No. 94-18-CFX
Status: GRANTED

Title: Antonio Mastrobuono and Diana G. Mastrobuono, Petitioners
v.
Shearson Lehman Hutton, Inc., et al.

Docketed:
June 28, 1994

Court: United States Court of Appeals for the Seventh Circuit

Counsel for petitioner: Harte,William J.

Counsel for respondent: Polizzotto,Joseph

| Entry | Date | Note | Proceedings and Orders |
|---|---|---|---|
| 1 | Jun 28 1994 | G | Petition for writ of certiorari filed. |
| 2 | Jul 28 1994 | | Brief of respondents Shearson Lehman Hutton Inc., et al. in opposition filed. |
| 3 | Aug 3 1994 | | DISTRIBUTED. September 26, 1994 (Page 83) |
| 4 | Aug 15 1994 | X | Reply brief of petitioners filed. |
| 6 | Oct 3 1994 | | REDISTRIBUTED. October 7, 1994 (Page 27) |
| 7 | Oct 7 1994 | | Petition GRANTED. The brief of petitioners is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Wednesday, November 16, 1994. The brief of respondents is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Tuesday, December 13, 1994. A reply brief, if any, is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Thursday, December 29, 1994. Rule 29.2 does not apply. |
| | | | ********** |
| 8 | Nov 3 1994 | | Record filed. |
| | | * | Partial proceedings United States Court of Appeals for the Seventh Circuit. |
| 9 | Nov 9 1994 | | Record filed. |
| | | * | Original record proceedings United States District Court for the Northern District of Illinois. |
| 10 | Nov 14 1994 | | SET FOR ARGUMENT TUESDAY, JANUARY 10, 1995. (2ND CASE). |
| 13 | Nov 15 1994 | | Brief amici curiae of United States, et al. filed. |
| 15 | Nov 15 1994 | G | Motion of American Association of Limited Partners for leave to file a brief as amicus curiae filed. |
| 11 | Nov 16 1994 | | Joint appendix filed. |
| 12 | Nov 16 1994 | | Brief of petitioners Antonio C. Mastrobuono, et ux. filed. |
| 16 | Nov 16 1994 | G | Motion of Public Investors Arbitration Bar Association for leave to file a brief as amicus curiae filed. |
| 18 | Nov 18 1994 | | CIRCULATED. |
| 21 | Nov 22 1994 | G | Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed. |
| 19 | Nov 28 1994 | | Motion of American Association of Limited Partners for leave to file a brief as amicus curiae GRANTED. |
| 20 | Nov 28 1994 | | Motion of Public Investors Arbitration Bar Association for leave to file a brief as amicus curiae GRANTED. |
| 22 | Dec 5 1994 | | Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED. |

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| Entry | Date | Note | Proceedings and Orders |
|---|---|---|---|
| 23 | Dec 13 1994 | X | Brief of respondents Shearson Lehman Hutton Inc., et al. filed. |
| 24 | Dec 13 1994 | X | Brief amicus curiae of Securities Industry Association filed. |
| 25 | Dec 29 1994 | X | Reply brief of petitioners filed. |
| 26 | Jan 10 1995 | | ARGUED. |

Supreme Court, U.S.
FILED
94-18 JUN 28 1994
OFFICE OF THE CLERK

No.

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1993

**Antonio C. Mastrobuono and Diana G. Mastrobuono,**

*Petitioners,*

v.

**Shearson Lehman Hutton Inc., a corporation, Nick DiMinico, Richard F. Benzer, and Mark Stevenson,**

*Respondents.*

**Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## PETITION FOR WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

1. Whether the Seventh Circuit erred in holding, contrary to the rulings of the First, Eighth, Ninth and Eleventh Circuits, that the law of a state named in a choice of law provision, rather than the Federal Arbitration Act, governs the arbitrability of a claim for punitive damages arising out of a contract which evidences a transaction involving commerce and which contains a comprehensive arbitration clause.

2. Whether the Seventh Circuit erred in holding, contrary to the precedent of this Court and the Eleventh Circuit, that a party to a contract waives the right to recover punitive damages by entering into a contract which provides that the agreement is governed by the law of a state which does not permit arbitral

awards of punitive damages and a comprehensive arbitration clause.



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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1994

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Antonio C. Mastrobuono and
Diana G. Mastrobuono,
Petitioners,

v.

SHEARSON LEHMAN HUTTON INC.,
Nick DiMinico, Richard F. Benzer, and
Mark Stevenson,
Respondents.

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Petition for Writ of Certiorari to the
United States Court of Appeals
For the Seventh Circuit

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**PETITION FOR WRIT OF CERTIORARI**

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Petitioners, Antonio C. Mastrobuono and Diana G. Mastrobuono (hereinafter "petitioners") respectfully pray that a writ of certiorari issue to review the

judgment and opinion of the United States Court of Appeals for the Seventh Circuit, entered in this cause on March 30, 1994.[1]

**CITATIONS TO OPINIONS BELOW**

The decision of the Court of Appeals for the Seventh Circuit (hereinafter the "Seventh Circuit") is reported at 20 F.3d 713 (1994), and is reprinted in full in the appendix hereto at App. 1 - App. 27.

The order of the United States District Court for the Northern District of Illinois, Eastern Division (C. Norgle) is reported at 812 F.Supp. 845 (N.D. Ill. 1993), and is reprinted in full in the appendix hereto at App. 28 - App. 43.

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[1] Counsel for petitioners wish to acknowledge the assistance in the preparation of this Petition For Writ Of Certiorari of law student Ricky G. Olcyzk.



**STATEMENT OF JURISDICTION**

Petitioners seek review of the decision of the Seventh Circuit entered on March 30, 1994, affirming the District Court's order vacating the arbitrators' award of punitive damages in favor of petitioners and denying petitioners' motion, in the alternative, for a trial on petitioners' punitive damages claims.

Jurisdiction is conferred upon this Court to review the March 30, 1994 judgment of the Seventh Circuit by 28 U.S.C. §1254(1).

**STATUTE INVOLVED**

9 U.S.C. §2 provides:

> **Validity, irrevocability, and enforcement of agreements to arbitrate.**
>
> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the

whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. §10(a) provides:

**Award of Arbitrators; vacation; grounds; rehearing.**

(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration -

(1) Where the award was procured by corruption, fraud, or undue means.

(2) Where there was evident partiality or corruption in the arbitrators, or either of them.

(3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.

(4) Where the arbitrators exceeded their powers, or so imperfectly



executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

(5) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

**STATEMENT OF THE CASE**

In October, 1985, respondent Nick DiMinico ("DiMinico"), a licensed representative and vice-president of respondent Shearson Lehman Hutton, Inc. (hereinafter "Shearson"), solicited petitioners to open a securities trading account with Shearson. Petitioners executed Shearson's standard form Client's Agreement.

Paragraph 13 of the Client's Agreement provided, in relevant part:

This agreement ... shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to

> transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Board of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as I may elect....[2]

DiMinico serviced petitioners' account and, during the course of his handling of the account, engaged in various forms of misconduct, including unauthorized trading and churning. In 1987, after incurring substantial losses, petitioners closed their account.

In January, 1989, petitioners filed suit in the United States District Court for the Northern District of Illinois, alleging that Shearson and DiMinico (hereinafter collectively "respondents")

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[2] The complete text of Paragraph 13 of the Client's Agreement is set forth at App. 44.



had subjected their account to unauthorized trading, churning and margin exposure. In their complaint, petitioners stated federal claims and state statutory and tort claims, with a prayer for punitive damages on the state claims. Jurisdiction of the District Court was invoked pursuant to 28 U.S.C. §1331 (federal question), with the District Court exercising original jurisdiction over petitioners' Securities Exchange Act claims and pendent (supplemental) jurisdiction over petitioners' state law claims.

In April, 1989, respondents moved, pursuant to the Federal Arbitration Act (hereinafter "FAA"), to compel arbitration before the National Association of Securities Dealers (hereinafter "NASD"). The District Court granted the motion.

Petitioners filed an amended complaint in arbitration, alleging violations of the NASD Rules of Fair Practice, SEC Rule 10b-5, §15-1 of the Securities Exchange Act, the Illinois Consumer Fraud Act, the Texas Deceptive Trade Practices-Consumer Protection Act, breach of fiduciary duty and negligence, with a request for punitive damages under the state law claims.

After the close of proofs in hearings conducted before a panel of three arbitrators, respondents submitted and the panel accepted respondents' Memorandum Regarding Claim For Punitive Damages and petitioners were given leave to file a reply. In their Memorandum respondents asserted, for the first time, that the arbitrators had no authority to award punitive damages.



The arbitrators awarded petitioners compensatory damages in the amount of $159,327.00 and punitive damages in the amount of $400,000.00.[3]

Respondents paid the compensatory damages award but moved in the District Court, pursuant to 9 U.S.C. §10(a)(4), to vacate the award of punitive damages. Respondents argued that New York law, the law governing the Client's Agreement, prohibits arbitrators from awarding punitive damages. Petitioners moved for confirmation of the arbitration award or,

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[3] Significantly, the NASD Arbitrator's Manual addresses the issue of punitive damages and provides that "[p]arties to an arbitration are informed that arbitrators can consider punitive damages as a remedy." Further, the NASD Rules of Fair Practice provide that "no agreement shall include any condition which ... limits the ability of arbitrators to make *any* award." [Emphasis added.] *Mastrobuono v. Shearson, Lehman, Hutton, Inc.*, 20 F. 3d 713, 717-718; App. at 15-17.

in the alternative, for a trial on their punitive damages claims. The District Court granted respondents' motion, vacating the punitive damages award, and denied petitioners' motion in its entirety.

On appeal, the Seventh Circuit affirmed the decision of the District Court, confirming the District Court's finding that the arbitrators had exceeded their power by awarding punitive damages.

**REASONS FOR ALLOWANCE OF THE WRIT**

This case presents significant issues relating to the enforcement of arbitration agreements pursuant to the Federal Arbitration Act (9 U.S.C. §1, *et seq.*) (hereinafter "FAA") and in accordance with "the liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural



policies to the contrary." *Moses H. Cone Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983).

In this case, the Seventh Circuit determined that a choice of law provision could be construed to defeat the clear intentions of the parties to arbitrate "any controversy arising out of or relating to [the petitioners'] accounts," and, in that guise, to resurrect the "judiciary's longstanding refusal to enforce agreements to arbitrate," which the FAA was specifically enacted to defeat. *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219-220, 105 S.Ct. 1238, 84 L.Ed.2d 158 (1985); *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 474, 109 S.Ct. 1248, 103 L.Ed.2d 488 (1989).

Significantly, the decision of the Seventh Circuit in this case reflects a clear and ever-widening split of authority among the Circuit Courts of Appeal on the precise issue presented. Consistent with the provisions of the FAA and the policies embodied in that Act, the First, Eighth, Ninth and Eleventh Circuits have ruled that a choice of law provision contained in an agreement which also contains a broad arbitration clause does not operate to preclude an arbitral award of punitive damages; the Second and Seventh Circuits have ruled to the contrary, relying on this Court's decision in *Volt, supra*.

This split of authority reflects diametrically opposed interpretations of the *Volt* decision. With regard to the issue presented, a plaintiff's ability to recover punitive damages in arbitration is



governed not by substantive legal considerations, but by the propriety of venue in a District Court of the First, Eighth, Ninth or Eleventh Circuits; if venue is proper only in a District Court of the Second or Seventh Circuits, a plaintiff may not enforce an arbitral award of punitive damages under identical circumstances. In other words, geographic fortuity, rather than a consistently applied rule of law, informed by legal analysis and equitable considerations, controls the arbitral remedies available to a plaintiff. Final binding resolution of the issue by this Court is the only way in which this manifestly unacceptable situation may be rectified.

In addition, absent review and reversal by this Court, the incorrect application by the Seventh Circuit (and

the Second Circuit) of the decision in *Volt* will serve to render the FAA a nullity as to any contract which contains a choice of law provision. In contravention of the express intentions of Congress in enacting the FAA, under the Seventh Circuit's erroneous construction of *Volt*, longstanding judicial prejudices against arbitration, as reflected in the decisions of the various states (*e.g.*, *Garrity v. Stuart*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976)), will be enforced under the pretense that, broad arbitration clauses notwithstanding, the parties intended to limit the power of the arbitrators by virtue of a choice of law clause. Accordingly, review by this Court is also necessary to clarify the appropriate application of the decision in *Volt*.



## I. THE SEVENTH CIRCUIT'S INCORRECT DETERMINATION THAT THE LAW OF A STATE NAMED IN A CHOICE OF LAW PROVISION, RATHER THAN THE FAA, DETERMINES WHETHER AN ARBITRATOR HAS THE AUTHORITY TO AWARD PUNITIVE DAMAGES, CONFLICTS WITH THE DECISIONS OF THE FIRST, EIGHTH, NINTH AND ELEVENTH CIRCUITS ON THE SAME MATTER, CONTRAVENES THE POLICIES UNDERLYING THE FAA AND MISAPPLIES THE DECISIONS OF THIS COURT.

### A. The Seventh Circuit's Decision In This Case Directly Conflicts With The Decisions Of The First, Eighth, Ninth And Eleventh Circuits And Deepens The Split Of Authority Among The Circuits On The Issue Presented.

In this case, in reaching its decision that the arbitration panel lacked authority to award punitive damages, the Seventh Circuit relied upon the inclusion in the Client's Agreement of a New York choice of law provision and the fact that, under New York state law, arbitrators are precluded from awarding punitive damages. (*Garrity v. Stuart*, 40 N.Y.2d 354, 386

N.Y.S.2d 831, 353 N.E.2d 793 (1976)). Relying on this Court's decision in *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 109 S.Ct. 1248, 103 L.Ed.2d 488 (1989),[4] the Seventh Circuit found

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[4] In *Volt*, the contract at issue contained a comprehensive arbitration clause and a choice of law provision which, under the facts presented, made clear that the agreement was to be governed by California law. In determining the applicability of California rules of arbitration, as set forth in the California Arbitration Act, this Court held that "application of the California [Arbitration] Act is not pre-empted by the Federal Arbitration Act ... in a case where the parties have agreed that their arbitration agreement will be governed by the law of California." *Volt*, 489 U.S. at 470. In reaching its decision, the Court stated that Section 4 of the FAA only confers the right to obtain an order directing arbitration to proceed in the manner provided for in the parties' agreement, and that the federal policy favoring arbitration was not offended by the California state court's interpretation of the choice of law provision as an indication of the parties' intent that the California rules of arbitration apply. *Volt*, 489 U.S. at 474-475. Finally, the Court concluded that enforcement of the agreement did not undermine the goals and policies of the FAA. *Volt*, 489 U.S. at 477-479.



that by including a New York choice of law provision, without excluding New York's arbitration rules, the parties had adopted the ruling in *Garrity* as "a binding rule." *Mastrobuono v. Shearson Lehman Hutton Inc.*, 20 F.3d at 717; App. at 12.

In *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117 (2nd Cir. 1991), the Second Circuit reached the same conclusion, using a similar analysis, in construing essentially the same contractual provision at issue here. (*See also, Fahnestock & Co., Inc., v. Waltman*, 935 F.2d 512 (2nd Cir. 1991)).

The decisions of the Seventh Circuit in this case and the Second Circuit in *Barbier* directly conflict with the decision of the First Circuit in *Raytheon*

*Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989); the Eighth Circuit in *Lee v. Chica*, 983 F.2d 883 (8th Cir. 1993), *cert. denied*, __ U.S. __, 114 S.Ct. 287, 126 L.Ed.2d 237 (1993); the Ninth Circuit in *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991); and the Eleventh Circuit in *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988).

In *Raytheon*, the First Circuit affirmed an arbitral award of punitive damages finding that the parties had agreed to submit all disputes arising out of their exclusive dealership contract to arbitration conducted according to the rules of the American Arbitration Association (hereinafter "AAA"). The First Circuit acknowledged that "the broad policies of the Federal Arbitration Act"



governed its analysis and that the FAA expresses a strong federal policy in favor of arbitration. *Raytheon*, 882 F.2d at 9. Using these considerations as the general context for its inquiry, the court further considered the fact that the arbitration clause contained in the parties' contract was "neither limited in its scope nor optional in its application" and the fact that it required arbitration to be conducted pursuant to the rules of the AAA, which "'grant any remedy or relief which is just and equitable and within the terms of the agreement of the parties.'" *Raytheon*, 882 F.2d at 9-10. In light of the generous construction which this Court has indicated should be accorded agreements to arbitrate (*Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, 473 U.S.

614, 105 S.Ct. 3346, 87 L.Ed.2d 444 (1985)), the First Circuit concluded:

> [I]t would seem sensible to interpret the "all disputes" and "any remedy or relief" phrases to indicate, at a minimum, an intention to resolve through arbitration any dispute that would otherwise be settled in a court, and to allow the chosen dispute resolvers to award the same varieties of relief as a court would be empowered to award. *Raytheon*, 882 F.2d at 10.

Further, the court noted and approved of the decisions of other jurisdictions which had held that a contract's choice-of-law provision does not require a reviewing court to determine whether arbitrators are empowered to award punitive damages by looking to the law of the chosen forum.

Although the First Circuit noted this Court's decision in *Volt*, it found that the *Volt* decision did not alter its



conclusions, distinguishing *Volt* on the basis that it involved the application of state procedural rules relating to arbitration, not the construction of the scope of an arbitration agreement.

Similarly, in *Lee v. Chica*, 983 F.2d 883 (8th Cir. 1993), *cert. denied*, ___ U.S. ____, 114 S.Ct. 287, 126 L.Ed.2d 237 (1993), the Eighth Circuit affirmed an arbitral award of punitive damages in a dispute arising out of a brokerage customer agreement. On appeal, the Eighth Circuit framed the issue before it as "whether federal or state law applies in interpreting the arbitration clause in the agreement and in determining if arbitrators can award punitive damages." *Lee*, 983 F.2d at 885. The Eighth Circuit rejected the line of reasoning applied by the Seventh Circuit in this case, ruling

that federal law, not state law, governed the issue. The court further noted that the parties had agreed that any arbitration would be conducted in accordance with the rules of the AAA, that the rules of the AAA permitted awards of punitive damages, and that the FAA gives force to the rules of the AAA. *See Lee*, 983 F.2d at 887-888.

In *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991), the Ninth Circuit affirmed an arbitral award of $1 million, rejecting the defendant's assertion that a New York choice of law provision contained in the parties' contract precluded an arbitration award of punitive damages. In this respect, the Ninth Circuit held that federal law, rather than New York state law, controlled, and that federal law



permitted arbitral awards of punitive damages. *Todd*, 943 F.2d at 1062-1063.

In reaching its decision, the Eleventh Circuit distinguished this Court's decision in *Volt*, finding that the Court "merely said that it would not disturb a state court's factual determination that the parties to the contract in *Volt* intended to invoke California arbitration rules." *Todd*, 943 F.2d at 1062, citing *Volt*, 109 S.Ct. at 1255.

In *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988), the defendant argued that a panel of arbitrators lacked power under a brokerage customer agreement, containing a New York choice of law provision, to award punitive damages. The customer agreement at issue also contained a broadly worded

arbitration clause and provided that arbitration was to be held in accordance with the rules of the Arbitration Committee of the Chamber of Commerce of the State of New York, the American Arbitration Association or the Board of Arbitration of the New York Stock Exchange, as selected by the plaintiffs. Relying on its earlier decision in *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*, 598 F.Supp. 353, *affirmed*, 776 F.2d 269 (11th Cir. 1985), as well as this Court's decision in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983), the Eleventh Circuit concluded that any doubts concerning the scope of arbitrable issues were to be resolved in favor of arbitration and that the arbitrators



could, upon remand, award punitive damages if they found that the facts warranted such an award.[5] The court reaffirmed the conclusions reached in *Willoughby*, stating:

> [A] choice of law provision in a contract governed by the Arbitration Act merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages; it does not deprive the arbitrators of their authority to award punitive damages. *Bonar*, 835 F.2d at 1387, citing *Willoughby*, 598 F.Supp. at 359.

In this case, although the Seventh Circuit noted these decisions, it rejected them, stating, "Unlike the First, Eighth, Ninth and Eleventh Circuits, we draw a distinction between the scope of

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[5] Based on false testimony given in the arbitration by plaintiffs' expert, the court determined that remandment was necessary.

arbitrable issues and the availability of punitive remedies." *Mastrobuono,* 20 F.3d at 718; App. 19-20. Contrary to the Seventh Circuit's ruling, however, the authority of arbitrators to award punitive damages or to otherwise determine the claims for relief between the contracting parties, and to fashion an appropriate remedy, clearly presents a question relating to the scope of arbitrable issues, not the procedural rules governing arbitration. In fact, as discussed *infra*, in *Garrity*, in ruling that arbitrators could not award punitive damages, the New York Court did not address the issue as a question of procedure. To the contrary, the court expressed the issue as a question of the scope of an arbitrator's power and the ability of contracting parties to define the scope of an



arbitrator's authority, versus the realm of exclusive judicial authority. With regard to contracts evidencing transactions involving commerce, such an issue is clearly governed by the FAA. As this Court in *Volt*, reiterated:

> In recognition of Congress' principal purpose of ensuring that private arbitration agreements are enforced according to their terms, we have held that the FAA pre-empts state laws which "require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Volt*, 489 U.S. at 478-479. [Citations omitted.]

Finally, even if the power of arbitrators could be characterized as a procedural question, under this view, the contract is ambiguous because it incorporates both the New York "rule" against arbitral awards of punitive damages and "the rules then in effect, of

the National Association of Securities Dealers," under which punitive damages may be awarded. In accordance with federal policy, any such ambiguity should have been determined in favor of arbitration.

B. The Seventh Circuit's Decision In This Case Contravenes The Provisions Of The FAA And The Policies Underlying That Act.

In reaching its decision in this case, the Seventh Circuit concluded that the state law of New York, as set forth in *Garrity v. Stuart*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976), rather than the FAA, controlled the issue of petitioners' ability to recover punitive damages in arbitration. The decision in *Garrity*, which both the Seventh Circuit in this case and the Second Circuit in *Barbier* found controlling, exemplifies both the refusal to enforce agreements into which parties



have entered and the antiquated jealousy with which the judiciary has traditionally regarded arbitrators and which Congress sought to obviate through enactment of the FAA. (*See Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219-220, 105 S.Ct. 1238, 84 L.Ed.2d 158 (1985)). In *Garrity*, a split New York Court of Appeals concluded that an arbitrator has no power to award punitive damages even if the parties had agreed to such an award.[6] *Garrity*, 40 N.Y.2d at 356, 359-360. In reaching its decision, the New York court held that punitive damages is a sanction reserved to the State and that enforcement of an arbitral award of punitive damages

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[6] Three justices concurred in the majority opinion, written by Chief Judge Breitel, with two justices concurring in the dissent written by Judge Babrielli.

would violate strong public policy. *Garrity*, 40 N.Y.2d at 357.

Numerous passages in the *Garrity* decision illustrate the judicial disdain for arbitration which the FAA was intended to overcome. For example, in *Garrity*, the New York court held:

> It is also true that arbitrators generally are free to fashion the remedy appropriate to the wrong, if they find one, but an authentic remedy is compensatory and measured by the harm caused and how it may be corrected. These broad principles are tolerable so long as arbitrators are not thereby empowered to ride roughshod over strong policies in the law which control coercive private conduct and confine to the State and its courts the infliction of punitive sanctions on wrongdoers. *Garrity*, 40 N.Y.2d at 357. [Citations omitted.]

The court further stated:

> Even if the so-called "malicious" breach here involved would permit of the imposition of punitive damages by a court or jury, it was not the province



> of arbitrators to do so. Punitive sanctions are reserved to the State, surely a public policy "of such magnitude as to call for judicial intrusion." The evil of permitting an arbitrator whose selection is often restricted or manipulatable by the party in a superior bargaining position, to award punitive damages is that it displaces the court and the jury and therefore the State, as the engine for imposing a social sanction. *Garrity*, 40 N.Y.2d at 358. [Citations omitted.]

The decision of the Seventh Circuit in this case serves to enforce such discredited and contemptuous views of arbitration, in contravention of the FAA, by incorporating state court precedent relating to the arbitrability of claims into all arbitration agreements containing a choice of law provision. Absent reversal by this Court, the reasoning adopted by the Seventh Circuit (and the Second Circuit), will effectively permit the preemption of the FAA by state law by

means of "back door" choice of law clauses.

**II. THE SEVENTH CIRCUIT INCORRECTLY RULED THAT, BY AGREEING TO A COMPREHENSIVE ARBITRATION CLAUSE AND TO THE SELECTION OF A FORUM IN A CHOICE OF LAW CLAUSE WHICH DOES NOT PERMIT PUNITIVE DAMAGES, PETITIONERS WAIVED THEIR RIGHTS TO RECOVER PUNITIVE DAMAGES.**

In reaching its decision in this case the Seventh Circuit concluded not only that petitioners' punitive damages claims were not arbitrable but also that petitioners had waived any right to recover punitive damages because, "[u]nder the plain language of the agreement, the [petitioners] are entitled only to the damages available in arbitration under New York law." *Mastrobuono,* 20 F.3d at 718. Accordingly, the court ruled that, by agreeing to both a comprehensive arbitration clause and a New York choice of law provision, petitioners had



implicitly waived any right to recover punitive damages, regardless of the forum, and were not entitled to proceed in the District Court on their punitive damages claims. This ruling, however, clearly conflicts with the decisions of this Court which have defined a waiver as a voluntary and intentional relinquishment of a known right (*see e.g., Johnson v. Zerbst,* 304 U.S. 458, 464, 58 S.Ct. 1019, 82 L.Ed. 1461 (1938)), as well as the Eleventh Circuit's decision in *Bonar v. Dean Witter Reynolds, Inc.,* 835 F.2d 1378, 1387-1388 (11th Cir. 1988), which refused to find a waiver under circumstances essentially identical to those presented here.[7]

Moreover, the decision of the Seventh Circuit undermines the efficacy of arbitration as a means of alternative

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[7] See *supra,* pp. 23-25.

dispute resolution; under the Seventh Circuit's decision, comprehensive arbitration clauses have become traps for the unwary. According to the rationale adopted by the Seventh Circuit, by agreeing to an arbitration clause and a choice of law provision, parties to a contract have automatically agreed to waive any claims which, through a misguided scorn for arbitration, the courts of the chosen forum may have imposed on arbitrators in that forum. For this reason, as well as the reasons discussed above, the decision of the Seventh Circuit in this case must be reversed if arbitration is to remain a viable and desirable means of resolving disputes.



**CONCLUSION**

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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# APPENDIX

**IN THE**
**UNITED STATES COURT OF APPEALS**
**FOR THE SEVENTH CIRCUIT**

---

No. 93-1581

---

ANTONIO C. MASTROBUONO and
DIANA G. MASTROBUONO,

*Plaintiffs-Appellants,*

v.

SHEARSON LEHMAN HUTTON INC., a
corporation, NICK DIMINICO,
RICHARD F. BENZER, and
MARK STEVENSON,

*Defendants-Appellees.*

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Argued October 26, 1993
March 30, 1994, Decided

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Before BAUER AND COFFEY, *Circuit Judges*

and SKINNER, *District Judge*.[1]

Skinner, District Judge.

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[1] Hon. Walter Jay Skinner of the District of Massachusetts, sitting by designation.

An arbitration panel awarded $400,000 in punitive damages to the customers of a brokerage firm on their claims of unauthorized trading, churning, and margin exposure. The district court vacated the award because New York law, the governing law chosen by the parties, does not permit arbitrators to award punitive damages. We affirm.

In October 1985, the plaintiffs-appellants, Antonio and Diana Mastrobuono ("plaintiffs"), opened a brokerage account with Shearson Lehman Hutton, Inc. ("Shearson"). The plaintiffs are Illinois residents. Nick DiMinico, a vice president and licensed representative of Shearson in its Houston, Texas office, solicited and serviced the plaintiffs' account. Although Shearson's principal place of business is in New York, the most



significant contacts in this case were with Illinois.

Paragraph 13 of the Client Agreement between plaintiffs and Shearson provides:

> This agreement...shall be governed by the laws of the State of New York...[A]ny controversy arising out of or relating to [the plaintiffs'] accounts...shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Board of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as [the plaintiffs] may elect...

In January 1989, the plaintiffs filed suit in the United States District Court for the Northern District of Illinois, claiming that the defendants had subjected their account to unauthorized trading, churning, and margin exposure. Plaintiffs stated federal claims and state statutory and tort claims; they requested punitive damages on the state claims. In April

1989, Shearson moved to compel arbitration before the National Association of Securities Dealers ("NASD"). The district court granted the motion.

The plaintiffs filed an amended complaint in arbitration, alleging violations of the NASD Rules of Fair Practice, SEC Rule 10b-5, § 15-1 of the Securities Exchange Act, the Illinois Consumer Fraud Act, the Texas Deceptive Trade Practices-Consumer Protection Act, breach of fiduciary duty and negligence. The plaintiffs again sought punitive damages under the state law claims, including treble and punitive damages under the Texas statute. Hearings on all of the claims were held in Chicago, Illinois on August 11-12 and September 29, 1992 before a panel of three arbitrators. On the last day of the hearings, after the



close of proofs, Shearson submitted a Memorandum Regarding Claim for Punitive Damages, arguing that the panel had no authority to award punitive damages. The panel accepted the filing and permitted plaintiffs to file a reply memorandum.

The panel awarded the plaintiffs $115,274.00 for commissions and $44,053.00 for margin interest "as satisfaction for their claims." Shearson has paid the compensatory damages portion of the award. The panel also awarded $400,000 in punitive damages. Shearson filed a motion in the district court to vacate the award of punitive damages because New York law, the governing law of the Client Agreement, precludes an arbitral award of punitive damages. The plaintiffs moved to confirm the award, or in the alternative for a trial on the amount of punitive damages to

be awarded, or as a further alternative for a trial on the punitive damages claims.

The district court denied the plaintiffs' motion and vacated the award of punitive damages under § 10(a)(4) of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 10(a)(4). 812 F.Supp. 845 (N.D.Ill. 1993). The court held that the plaintiffs had "contractually waived any potential award of punitive damages in arbitration," *id.* at 846, and that the arbitrators exceeded their power by making the award. The court denied the motion to sever the punitive damages claims for trial because punitive damages were precluded by the arbitration agreement, and because neither Illinois nor New York law permits a separate cause of action



solely for punitive damages. This appeal followed.

**SHEARSON'S WAIVER**

The plaintiffs argue that Shearson waived its objections to the claim for punitive damages by not raising the issue until the proofs in arbitration had closed. We disagree. The plaintiffs had an opportunity to respond to Shearson's late submission, and they certainly were not prejudiced in any way. The arbitrators and the district court had the opportunity to consider the arguments of both parties.

**DISCUSSION**

**I. Scope of review**

We first address plaintiffs' argument that the district court violated the standard of review imposed by the Federal Arbitration Act. In relevant part,

§10(a)(4) of the FAA permits a court to vacate an award "[w]here the arbitrators exceeded their powers." The arbitrator's errors of law and contract construction are normally unreviewable under this standard. *Chicago Typographical Union No. 16 v. Chicago Sun-Times, Inc.*, 935 F.2d 1501 (7th Cir. 1991). However, our narrow scope of review does not immunize an award clearly unauthorized by the terms of the agreement. *See Miller Brewing Co. v. Brewery Workers Local Union No. 9*, 739 F.2d 1159, 1164 (7th Cir. 1984), *cert. denied*, 469 U.S. 1160, 105 S.Ct. 912, 83 L.Ed.2d 926 (1985) (court may reverse award that "clearly" was not "within the contemplation of the parties and...implicitly authorized by the agreement"). As the Court of Appeals for the Second Circuit has observed, where the



arbitrators are not entitled to award punitive damages due to a choice of law provision in the parties' agreement, it is "manifest" that the arbitrators would exceed their powers by awarding punitive damages. *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991). "[T]here is no clearer case of a case falling...within" § 10(a)(4) of the Act. *Id.* The district court properly reviewed the panel's authority to award punitive damages.

**II. Enforcement of the arbitration agreement**

The FAA created "a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate." *Moses H. Cone Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n.32, 103 S.Ct. 927, 942 n. 32, 74 L.Ed.2d 765 (1983). Because there is a "liberal

federal policy favoring arbitration agreements," *id.* at 24, 103 S.Ct. at 941, courts should "liberally construe the scope of arbitration agreements." *Mitsubishi Motors v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 627, 105 S.Ct. 3346, 3354, 87 L.Ed.2d 444 (1985). Doubts concerning "the scope of arbitrable issues" should be resolved in favor of arbitration. *Moses H. Cone*, 460 U.S. at 24-25, 103 S.Ct. at 941-42. However, the federal policy "is simply to ensure the enforceability, *according to their terms*, of private agreements to arbitrate." *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468, 476, 109 S.Ct. 1248, 1254, 103 L.Ed.2d 488 (1989) (emphasis added). We may not rewrite the agreement to enhance



arbitrability or otherwise expand the scope of the arbitrator's powers.

Under New York law, the governing law of the agreement, arbitrators may not award punitive damages. *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 831-32, 353 N.E.2d 793, 794 (1976). The plaintiffs argue at length that the Garrity rule as applied to the agreement is preempted by the FAA. Preemption becomes an issue only if the parties intended to arbitrate on terms foreclosed by applicable state law:

> Where, as here, the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA, even if the result is that arbitration is stayed where the Act would otherwise permit it to go forward. By permitting courts to "rigorously enforce" such agreements according to their terms...we give effect to the contractual rights and

> expectations of the parties, without doing violence to the policies behind the FAA.

*Volt*, 489 U.S. at 479, 109 S.Ct. at 1256. Here the parties agreed to arbitrate all of their controversies under New York law. By choosing New York law without excluding its arbitration rules, the parties adopted *Garrity* as a binding rule.

In *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984), we examined a brokerage agreement that also compelled arbitration of all controversies under New York law. Although the plaintiffs in *Pierson* may not have realized that "the plain wording of their arbitration clause" precluded any award of punitive damages, we held that "the Piersons cannot use their failure to inquire about the ramifications of that



clause to avoid the consequences of agreed-to arbitration." *Id.* at 338-39.

Notwithstanding *Pierson*, the plaintiffs argue that the *Garrity* rule is inapplicable here because the agreement does not expressly bar punitive damages. Paragraph 13 of the agreement provides that "any controversy arising out of or relating to" the plaintiffs' account "shall be settled by arbitration." According to the plaintiffs, a demand for punitive damages is a "controversy" which, in the absence of an express exclusion from a broad arbitration clause, must be submitted to arbitration.

We do not think the *Garrity* rule can be characterized as a specific exclusion from the arbitration agreement. Submission to New York law is a general condition upon the arbitration of all

"controvers[ies]" between the parties. Because any condition imposed by New York law can be found in the books, a choice of law provision suffices to incorporate the *Garrity* rule. By contrast, specific exclusions must be stated in the arbitration agreement because they cannot be gleaned from another source.

In *Pierson*, we did not address the argument that some other provision of the agreement authorized punitive damages, *contra* the choice of New York law. The plaintiffs argue that the arbitration rules of the NASD incorporated by reference in ¶ 13 of the agreement, expressly authorize arbitrators to award punitive damages.

The NASD Code of Arbitration Procedures is "prescribed and adopted...for the arbitration of any



dispute, claim or controversy" connected with the business of an NASD member. § 1. Section 41(e) of the Code states that the arbitral award "shall contain...a summary of...the damages and other relief awarded." Neither of these procedural provisions confers a substantive right to a particular type of damages. *Cf. Fahnestock & Co., Inc. v. Waltman*, 935 F.2d 512, 518 (2d Cir. 1991) (the *Garrity* rule is a rule of state substantive law).

Unlike the Code of Arbitration Procedures, the NASD Arbitrator's Manual specifically addresses punitive damages:

> B. Punitive Damages
>
> The issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy.

We do not think that this provision of the Manual authorizes an award of punitive

damages in derogation of the governing law of the agreement. New York law applies no matter which set of arbitral rules the plaintiffs happen to choose. The Court of Appeals for the Second Circuit has held that the arbitration rules of the New York Stock Exchange -- which were also available to the plaintiffs -- do not empower arbitrators to award punitive damages. *Fahnestock*, 935 F.2d at 519. We do not think the parties intended the availability of punitive damages to vary with the plaintiffs' choice of arbitration rules. The more sensible construction of the agreement is that the *Garrity* rule always controls, whether the plaintiffs choose NASD, NYSE, or American Stock Exchange rules.

For the same reasons, the NASD Rules of Fair Practice do not override the



parties' choice of New York law. Section 21(f)(4) of the Rules provides that "[n]o agreement shall include any condition which...limits the ability of the arbitrators to make *any* award" (emphasis added). To the extent that this provision conflicts with New York law, the governing law of the agreement under all circumstances, we must conclude that the parties intended to be bound by New York law.

The plaintiffs urge us to resolve any conflict between NASD rules and New York law in favor of the award of punitive damages. That is not quite what federal policy requires. Moses H. Cone, 460 U.S. at 24-25, 103 S.Ct. at 941-42, states that "any doubts concerning the *scope of arbitrable issues* should be resolved in favor of arbitration" (emphasis added).

The Client Agreement does not purport to withhold certain issues from arbitration. In fact, it refers all "controvers[ies]" to arbitration -- subject always to the strictures of New York law. We think the policy favoring arbitrability applies with less force when there are doubts concerning the availability of punitive remedies - as opposed to the "scope of arbitrable issues." *Cf. Independent Employees' Union v. Hillshire Farm Co.*, 826 F.2d 530, 535 (7th Cir. 1987) ("[t]his court and other arbitrators have recognized that arbitral remedies, with few exceptions, may not be punitive"). Just as the FAA does not favor or disfavor arbitration under a given set of procedural rules, *Volt*, 489 U.S. at 476, 109 S.Ct. at 1254, neither does it favor or disfavor any particular type of



remedy. We construe the arbitration agreement liberally, as we must, but we need not automatically resolve all doubts so as to authorize punitive damages.

We recognize that some circuit courts have reached a different result. *See Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988); *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991); *Lee v. Chica*, 983 F.2d 883 (8th Cir.), *cert. denied*, __ U.S. __, 114 S.Ct. 287, 126 L.Ed.2d 237 (1993). We prefer to follow the implications of our decisions in *Pierson* and *Hillshire Farm, supra*. Unlike the First, Eighth, Ninth, and Eleventh Circuits, we draw a distinction between the scope of arbitrable issues and the availability of

punitive remedies. We resolve any apparent conflict between New York law and the NASD rules in favor of New York law, the generally applicable law of the agreement. *Cf. Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991) (vacating arbitral award of punitive damages because "the parties elected to abide by 'the laws of the State of New York' in the event of a dispute under the Agreement").

Given our conclusion that the parties wished to arbitrate all of their disputes subject to *Garrity*, there is no need to consider whether the *Garrity* rule is preempted by the FAA or by the federal common law "govern[ing] the construction of arbitration agreements," *Raytheon*, 882 F.2d at 11 n.5. "Interpreting a choice-of-law clause to make applicable state



rules governing the conduct of arbitration...does not offend the rule of liberal construction set forth in *Moses H. Cone*, nor does it offend any other policy embodied in the FAA." *Volt*, 489 U.S. at 476, 109 S.Ct. at 1254. We also reject the plaintiffs' contention that the district court should at least have severed the punitive damages claims for trial. Under the plain language of the agreement, the plaintiffs are entitled only to the damages available in arbitration under New York law.

**III. Conflict of laws**

The plaintiffs argue that the choice of law provision includes all New York law, even its conflict of laws principles. According to the plaintiffs, the district court erred by not applying New York conflicts law, which would have "bounced"

the applicable law from New York back to Illinois. We disagree. In *Sarnoff v. American Home Products Corp.*, 798 F.2d 1075, 1080 (7th Cir. 1986), where the contract also specified New York law, we observed that a federal court sitting in diversity should apply the conflicts law of the forum state. We have also held that in federal question cases, "the choice-of-law rule for pendent state claims should be that of the forum." *Baltimore Orioles, Inc. v. Major League Baseball Players Ass'n*, 805 F.2d 663, 681 (7th Cir. 1986), *cert. denied*, 480 U.S. 941, 107 S.Ct. 1593, 94 L.Ed.2d 782 (1987). Applying New York conflicts law to the state claims here would "[re]introduce the uncertainties of choice of law" and "defeat the basic objectives, namely those of certainty and



predictability, which the choice-of-law provision was designed to achieve." Restatement (Second) of Conflict of Laws §187(3), comment h (1988).

Under Illinois conflicts law, we may enforce the parties' chosen law if it is not "dangerous, inconvenient, immoral, [or] contrary to the public policy" of Illinois. *McAllister v. Smith*, 17 Ill. 328, 333 (1856). The plaintiffs argue that the *Garrity* rule is contrary to Illinois public policy because Illinois permits arbitrators to award punitive damages. As we noted in *Sarnoff*, 798 F.2d at 1081, Illinois courts have enforced the parties' choice of foreign law even where that law is arguably inconsistent with an Illinois statute. "[T]he public policy considerations must be strong and of a *fundamental* nature to justify overriding

the chosen law of the parties." *Potomac Leasing Co. v. Chuck's Pub, Inc.*, 156 Ill.App.3d 755, 109 Ill.Dec. 90, 93, 509 N.E.2d 751, 754 (1987) (emphasis added). The Illinois cases raise no such "fundamental" policy considerations against the *Garrity* rule. In fact, Illinois appears to disfavor arbitral awards of punitive damages. *See Edward Elec. Co. v. Automation, Inc.*, 229 Ill.App.3d 89, 171 Ill.Dec. 13, 23, 593 N.E.2d 833, 843, *app. denied*, 146 Ill.2d 625, 176 Ill.Dec. 796, 602 N.E.2d 450 (1992) (punitive damages may not be awarded in arbitration unless "the parties have expressly agreed to the arbitrators' authority to award punitive damages").

In Illinois, "[a] second recognized limitation to an express choice of law provision is the requirement that there be



some relationship between the chosen [law] and the parties or the transaction." *Potomac Leasing*, 109 Ill.Dec. at 93, 509 N.E.2d at 754. Shearson has conceded that the most significant contacts in this case were outside New York. That fact might be decisive if there were no contractual choice of law provision. However, as we observed in *Sarnoff*, 798 F.2d at 1082, it is reasonable for a corporation with far-flung interests to bargain for the law of its headquarters state. New York law is reasonably related to the parties because Shearson's principal place of business is New York. *See Janice Doty Unlimited, Inc. v. Stoecker*, 697 F.Supp. 1016, 1019-20 (N.D.Ill. 1988); *ISC-Bunker Ramo Corp. v. Altech, Inc.*, 765 F.Supp. 1310, 1335-36 (N.D.Ill. 1990). The district court

correctly applied New York law as the governing law of the agreement.

**IV. Predispute waiver of punitive damages**

The plaintiffs argue that a predispute waiver of punitive damages is void under the public policies of Texas and Illinois. This argument was not raised in the district court. Accordingly, it has been waived on appeal. *See Resolution Trust Corp. v. Juergens*, 965 F.2d 149, 153 (7th Cir. 1992).

**CONCLUSION**

Federal policy "favor[s] arbitration agreements," *Moses H. Cone*, 460 U.S. at 24, 103 S.Ct. at 941, not "arbitration" *per se*. The plaintiffs-appellants cannot avoid their own choice of governing law. The district court's order vacating the award of punitive damages and denying the plaintiffs' motion in the alternative for



a trial on the punitive damage claims is *affirmed*. Costs shall be awarded to the appellees.

UNITED STATES DISTRICT COURT,
NORTHERN DISTRICT OF ILLINOIS,
EASTERN DIVISION

89 C 0773

ANTONIO C. MASTROBUONO and
DIANA G. MASTROBUONO,

*Plaintiffs,*

v.

SHEARSON LEHMAN HUTTON INC., a
corporation, NICK DIMINICO,
RICHARD F. BENZER, and
MARK STEVENSON,

*Defendants.*

February 9, 1993

**ORDER**

NORGLE, District Judge.

Before the court is the motion of defendants Shearson Lehman Hutton Inc. ("Shearson") and Nick DiMinico ("DiMinico") to partially vacate an



arbitration award. For the following reasons, the motion is granted.

FACTS

In October, 1985, the plaintiffs, Antonio C. Mastrobuono and Diana G. Mastrobuono (the "Mastrobuonos"), opened a brokerage account with Shearson. The Mastrobuonos' account was solicited by DiMinico, who was the registered representative servicing their account. Upon opening their account, the Mastrobuonos entered into a Client Agreement (the "Agreement") with Shearson. Paragraph 13 of the Agreement stated that any controversy relating to the Mastrobuonos' account would be settled by arbitration and would be governed by New York law.

In January, 1989, the Mastrobuonos filed a lawsuit against the defendants,

claiming that their account had been subjected to unauthorized trading, churning, and margin exposure. The Mastrobuonos' complaint contained both federal and state law claims, including requests for punitive damages on the latter. After having been ordered by this court to arbitrate their dispute pursuant to paragraph 13 of the Agreement, the Mastrobuonos commenced arbitration proceedings before the National Association of Securities Dealers, Inc. ("NASD").

Arbitration hearings were conducted in August and September, 1992. On October 13, 1992, the arbitration panel executed their award, awarding the Mastrobuonos the sum of $115,274 in commissions and $44,053 in margin interest "as satisfaction for their claims." The arbitrators also



assessed punitive damages against Shearson and DiMinico in the amount of $400,000. Shearson has paid the compensatory damages awarded by the arbitration panel; with regard to the punitive damages, however, Shearson and DiMinico challenge the arbitrators' authority to bestow such an award.

DISCUSSION

The agreement specifically provides in Paragraph 13 that: "[t]his agreement...shall be binding on the undersigned...and shall be governed by the laws of the State of New York..." As the Seventh Circuit has expressly found, a customer of a brokerage firm who signs an agreement expressly governed by New York law has contractually waived any potential award of punitive damages in arbitration. *Pierson v. Dean, Witter, Reynolds, Inc.*,

742 F.2d 334, 337-39 (7th Cir.1984) ("the plain wording of the arbitration clause [meant] losing the possibility of obtaining punitive damages"..."which are not permitted in arbitration under New York law..."); *see Baselski v. Paine, Webber, Jackson & Curtis, Inc.*, 514 F.Supp. 535, 543 (N.D.Ill.1981) (parties to an arbitration agreement governed by the law of the State of New York have contractually waived "right" to punitive damages); *see also Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117 (2d Cir.1991) (New York law prohibits award of punitive damages in arbitration); *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 517 (2d Cir.), (same), *cert. denied*, ___ U.S. ___, 112 S.Ct. 380, 116 L.Ed.2d 331 (1991); *Melun Indust., Inc. v. Strange*, 1992 WL 8143 (S.D.N.Y. Jan. 10, 1992)



(same); *Shahmirzadi v. Smith Barney, Harris Upham & Co.*, 636 F.Supp. 49, 56 (D.D.C.1985) ("When the plaintiffs executed the Customer's Agreement, they contractually waived their right to punitive damages by agreeing to be governed by arbitration and New York law"); *Thomson McKinnon Securities v. Cucchiella*, 32 Mass.App.Ct. 698, 594 N.E.2d 870 (1992) (same).

The New York law that precludes arbitrators from awarding punitive damages is usually identified with the case of *Garrity v. Stuart*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976), which held that the imposition of punitive damages is a power reserved to the state and its courts. The Mastrobuonos argue that the Federal Arbitration Act, 9 U.S.C §1 *et seq*. (the "FAA"), which was designed

to "overrule the judiciary's longstanding refusal to enforce agreements to arbitrate," *Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213, 219-220, 105 S.Ct. 1238, 1242, 84 L.Ed.2d 158 (1985), preempts application of *Garrity*. While the FAA does not contain an express preemptive provision, it has been held to preempt state laws that preclude parties from submitting matters to arbitration. *See Perry v. Thomas,* 482 U.S. 483, 107 S.Ct. 2520, 96 L.Ed.2d 426 (1987) (FAA preempted state law holding wage actions not arbitrable); *Southhand v. Keating*, 465 U.S. 1, 104 S.Ct. 852, 79 L.Ed.2d 1 (1984) (FAA preempts state law precluding arbitration under state franchise act).

Although the FAA preempts state laws that require a judicial forum for the resolution of claims that contracting



parties have agreed to arbitrate, it does not create any independent rights to arbitrate. Accordingly, the Supreme Court found that enforcing an arbitration agreement's choice-of-law provision in accordance with the terms of that agreement is fully consistent with the goals of the FAA. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 477, 109 S.Ct. 1248, 1255, 103 L.Ed.2d 488 (1989). In *Volt*, the Supreme Court found that the liberal policy favoring arbitration did not provide any basis for ignoring choice-of-law provisions in arbitration agreements:

> There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate. Interpreting a choice-of-law clause to make applicable state rules governing the conduct of

> arbitration--rules which are manifestly designed to encourage resort to the arbitral process--simply does not offend the rule of liberal construction...nor does it offend any other policy embodied in the FAA.

*Id.* at 476, 109 S.Ct. at 1254.

In *Barbier v. Shearson Lehman Hutton, Inc.*, the Second Circuit specifically addressed the very same Client Agreement at issue in this case and rejected the argument "that the *Garrity* rule conflicts with federal law and thus is preempted by the FAA." 948 F.2d 117,121 (1991). Based on the holding in *Volt*, the Second Circuit concluded that the choice-of-law provision of paragraph 13 was not preempted by federal law and that the application of the *Garrity* rule furthered the policy of the FAA by enforcing the terms of the parties' arbitration agreement: "[i]t is apparent from the inclusion of the choice-



of-law provision that the parties intended to be bound by *Garrity*, and 'as with any other contract, the parties' intentions control'". *Id.* at 122 (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626, 105 S.Ct. 3346, 3354, 87 L.Ed.2d 444 (1985)).

In support of their federal preemption argument, the Mastrobuonos cite a trilogy of cases in which the Supreme Court rejected traditional judicial antipathy to arbitration and, based on the FAA, established the validity of arbitration as a means of resolving disputes. *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987); *Mitsubishi Motors*, 473 U.S. 614, 105 S.Ct. 3346; *Byrd*, 470 U.S. 213, 105 S.Ct. 1238. Based on these cases, the Mastrobuonos contend

that "the trend has been overwhelmingly to recognize that punitive damages are arbitrable." Whether punitive damages are arbitrable, however, is not an issue in the underlying dispute. Instead, at issue is whether punitive damages are an available remedy where an arbitration agreement is governed by New York law.

The *Volt* court found that, just as parties can limit the issues which they will arbitrate, so too may they specify the rules under which arbitration will be conducted. *Volt*, 489 U.S. at 477, 109 S.Ct. at 1255. Where the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA. Because the Mastrobuonos agreed to arbitrate their dispute in accordance with



laws of the State of New York, and because the Agreement does not explicitly or by incorporation authorize the award of punitive damages, the remedies available to them are limited by the *Garrity* rule. This limitation gives effect to the contractual rights and expectations of the parties and does not violate the policies codified in the FAA. Accordingly, the punitive damages awarded the Mastrobuonos are vacated pursuant to 9 U.S.C. § 10. *See First Commercial Fin. Group, Inc. V. Baghdoian*, 812 F.Supp. 837 (N.D.Ill. 1993) (discussing FAA grounds for vacating an arbitration award).

Subsequent to Shearson and DiMinico's motion to vacate, the Mastrobuonos filed a motion to confirm the arbitration award or, alternatively, to award punitive damages or set a date for trial on the

claims for which the imposition of punitive damages is usually allowed. As discussed above, the punitive damages award must be vacated in accordance with the terms of the Agreement's paragraph 13 and the *Garrity* rule; therefore, Mastrobuonos' motion to confirm must be denied.

In support of their request that this court award punitive damages, the Mastrobuonos contend that if New York law prohibits arbitrators from awarding punitive damages, the court could somehow retain jurisdiction over that remedy. By providing that New York law govern their agreement, the Mastrobuonos agreed that the damages available to them would be those awardable by arbitration under New York law. This was not a waiver by the defendants of their FAA-guaranteed right



to compel arbitration of this dispute, including the award of damages, *see* 9 U.S.C. § 4 (party has right to obtain an order directing that "arbitration proceed in the manner provided for in [the parties'] agreement"), but, instead, was the Mastrobuonos' waiver of their potential right to receive punitive damages. Accordingly, the court cannot, in disregard of the FAA, award damages that are precluded by the parties' privately negotiated arbitration agreement. *See Byrd*, 470 U.S. at 219, 105 S.Ct. at 1241.

Furthermore, as to whether the Mastrobuonos may separately litigate the remedy of punitive damages, both Illinois and New York law preclude a separate cause of action solely for punitive damages. *See Kemner v. Monsanto*, 217 Ill.App.3d

188, 199, 160 Ill.Dec. 192, 199, 576 N.E.2d 1146, 1153, *app. denied*, 142 Ill.2d 655, 164 Ill.Dec. 918, 584 N.E.2d 130 (1991) ("Illinois does not recognize a cause of action for punitive damages alone"); *McGrew v. Heinold Commodities, Inc.*, 147 Ill.App.3d 104, 110, 100 Ill.Dec. 446, 451, 497 N.E.2d 424, 429 (1986) ("Illinois, like most states, does not recognize a cause of action for punitive damages alone"); *Florsheim v. Travelers Indem. Co.*, 75 Ill.App.3d 298, 309-10, 30 Ill.Dec. 876, 886, 393 N.E.2d 1223, 1233 (1979) (same); *Waltman v. Fahnestock & Co.*, 792 F.Supp. 31, 33 (E.D.Pa.1992) (New York does not provide for a separate cause of action for punitive damages); *Santos v. Security & Law Enforcement Employees, Council 82*, 80 A.D.2d 554, 435 N.Y.S.2d 357, 358 (1981)



("[I]n this state there is no separate cause of action for punitive damages."). Accordingly, the Mastrobuonos' alternative motion to set a date for trial on their "pending claims for punitive damages" must be denied.

CONCLUSION

For the foregoing reasons, the motion of Shearson and DiMinico to vacate the Mastrobuonos' award of punitive damages is granted.

IT IS SO ORDERED.

Paragraph 13 of the Client's Agreement provides:

> This agreement shall inure to the benefit of your successors and assigns shall be binding on the undersigned, my heirs, executors, administrators and assigns, and shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [the petitioners'] accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as I may elect. If I do not make such election by registered mail addressed to you at your main office within 5 days after demand by you that I make such election, then you may make such election. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof. This agreement to arbitrate does not apply to future disputes arising under certain of the federal securities laws to the extent it has been determined as a matter of law that I cannot be compelled to arbitrate such claims.

Supreme Court, U.S.
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No. 94-18

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1994

**Antonio C. Mastrobuono and Diana G. Mastrobuono,**

*Petitioners,*

v.

**Shearson Lehman Hutton Inc., a corporation, Nick DiMinico, Richard F. Benzer, and Mark Stevenson,**

*Respondents.*

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## RESPONDENTS' BRIEF IN OPPOSITION

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13 pp

## QUESTION PRESENTED

Whether the Seventh Circuit correctly interpreted the particular arbitration agreement at issue in this case as precluding the arbitrators from awarding punitive damages?

## LIST OF PARTIES

Petitioners:

Antonio C. Mastrobuono

Diana G. Mastrobuono

Respondents:

Lehman Brothers Inc. (Lehman Brothers Inc. is the successor corporation to the corporation that was formerly known as Shearson Lehman Hutton Inc.).

Nick DiMinico

Richard F. Benzer and Mark Stevenson were not appellees in the court below and are not parties herein

The following is furnished in compliance with Supreme Court Rule 29.1:

Lehman Brothers Inc.

Parent Company—Lehman Brothers Holdings Inc.

Subsidiaries (except wholly owned)—None



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## RESPONDENTS' BRIEF IN OPPOSITION

## REASONS FOR DENYING THE WRIT

### I.

### PETITIONERS OFFER NO REASON WHY THE COURT SHOULD RECONSIDER ITS VERY RECENT REFUSALS TO REVIEW THE ISSUE INVOLVED IN THIS CASE

The Court at its last Term twice declined to review cases presenting the question of the power of arbitrators to award punitive damages under arbitration agreements like the one in this case. *Lee v. Chica*, 983 F.2d 883 (8th Cir.), *cert. denied*, ____ U.S. ____, 114 S. Ct. 287, 126 L. Ed. 2d 237 (Oct. 4, 1993); *J. Alexander Securities, Inc. v. Mendez*, 17 Cal. App. 4th 1083, 21 Cal. Rptr. 2d 826 (Cal. Ct. App. 1993), *cert. denied*, ____ U.S. ____, 114 S. Ct. 2182 (June 6, 1994). This case had been decided by the Seventh Circuit at the time the petition for certiorari in the *Mendes* case was before the Court. Indeed, the decision in this case was cited by two dissenting members of the Court. *See* 114 S. Ct. 2182 (Opinion of O'Connor, J., dissenting from the denial of certiorari). Nevertheless, this Court declined review in *Mendes*.

Petitioners do not suggest that there have been any developments since the Court's action last June 6th that make review any more desirable now than it was then. Nor do petitioners suggest any reason why the instant case is a more suitable vehicle for consideration of the issues than was the *Mendes* case. As discussed below, the conflicting results in the lower courts do not reflect significant disparities in their views as to the requirements of the Federal Arbitration Act ("FAA"). Rather, they involve varying interpretations of different contractual language. Moreover, it is doubtful that a decision of this Court could achieve uniformity or eliminate future disputes about how varying forms of arbitration agreements and the rules incorporated therein should be interpreted. Therefore, the petition should be denied.

## II.

## THE CASE DOES NOT PRESENT THE FIRST QUESTION STATED BY PETITIONERS

In attempting to frame a question calling for review by this Court, petitioners have significantly misstated the holding of the Seventh Circuit. The error invalidates petitioners' arguments for review.

Petitioners describe the Seventh Circuit as holding that the law of a state named in a choice of law provision "rather than the Federal Arbitration Act" governs the arbitrability of a claim for punitive damages. Pet. at i. The Seventh Circuit did not so hold. On the contrary, it expressly acknowledged not only that the FAA governed but that the Act requires that the scope of arbitration agreements be liberally construed and that doubts concerning the scope of arbitrable issues be resolved in favor of arbitrability. 20 F.3d at 716. The court then correctly analyzed the particular arbitration agreement as excluding punitive damages because the parties expressly adopted New York law. The court's deference to what it perceived as the clear meaning of the contract was consistent with—indeed, required by—the principle stated by this Court that the policy of the FAA "is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." *Volt Info. Sciences, Inc. v. Stanford Univ.*, 489 U.S. 468, 476, 109 S. Ct. 1248, 1254, 103 L. Ed. 2d 488 (1989).

The issue as stated by petitioners might be presented where, in contrast to this case, a court relies on diversity jurisdiction, rather than the express agreement of the parties, as the reason for adherence to state law, as was done in *Fahnestock & Co. v. Waltman*, 935 F.2d 512 (2d Cir.), *cert. denied*, 112 S. Ct. 380 (1991). But the Seventh Circuit did not follow the rationale of *Fahnestock* or suggest in any way that New York law might apply of its own force absent an agreement of the parties adopting that law.



Indeed, it is simply incorrect to read the Seventh Circuit's opinion as reflecting a predisposition to give state law that is hostile to arbitration priority over the FAA. Moreover, since the decision in this case, the Seventh Circuit has had occasion to revisit the question of arbitrators' power to award punitive damages in cases under the FAA and has expressly rejected the application of state law in the absence of an agreement between the parties expressly adopting state law. In doing so the court stated: "State common law hostile to arbitration is preempted by federal common law friendly to it." *Baravati v. Josephthal, Lyon & Ross, Inc.*, 1994 U.S. App. LEXIS 16587, at *23 (7th Cir., July 1, 1994).

In sum, this case provides no occasion for review by this Court for the purpose, as petitioners' arguments suggest, of correcting "the antiquated jealousy with which the judiciary has traditionally regarded arbitrators and which Congress sought to obviate through enactment of the FAA." *See* Pet. 28-32.

## III.

## THE DIFFERING RESULTS AMONG THE CIRCUITS TURN ON CONTRACT INTERPRETATION AND DO NOT PRESENT A CONFLICT SUITABLE FOR RESOLUTION BY THIS COURT

The question whether a particular arbitration agreement excludes punitive damages will inevitably depend on the terms of that agreement including, where a choice of law clause is involved, the possible effect of other provisions on the meaning of the choice of law clause. As the Seventh Circuit stated in *Baravati v. Josephthal, supra*:

> The difference between *Mastrobuono* and the contrary decisions is simply a difference over the proper interpretation of the choice of law clause read in light of the parties' agreement to have their disputes arbitrated under rules that allow for the award of punitive damages.

It is therefore clear that there is *no* conflict of legal principle between the decision in *Mastrobouno* and the decisions in the First, Eighth, Ninth and Eleventh circuits said to be in conflict with it. Rather, as the Seventh Circuit explains, the different results of those courts turn on the interpretations of different arbitration agreements.

In each of the Court of Appeals cases cited by petitioners the arbitration agreement included both a choice of law clause and a clause providing for arbitration under the Rules of the American Arbitration Association ("AAA"), which expressly authorize arbitrators to award "any remedy or relief which is just and equitable and within the terms of the agreement of the parties." In each case the court attached significance to the incorporation of the AAA rules as indicating that the parties did not intend by the choice of law clause to preclude an award of punitive damages. *See Raytheon v. Automated Bus. Sys., Inc.*, 882 F.2d 6, 11-12 n.5 (1st Cir. 1989); *Lee v. Chica*, 983 F.2d 883, 888 (8th Cir. 1993); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1063 & n.6 (9th Cir. 1991); *Bonar v. Dean Witter Reynolds Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988); *Willoughby Roofing & Supply v. Kajema Intern.*, 598 F. Supp. 353, 360 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985) (per curiam). Moreover, there appears to be no Court of Appeals case involving adoption of the AAA rules in which a choice of law clause has been held to preclude punitive damages.

In contrast, the arbitration agreement in the present case does not adopt the AAA rules. The rules it does



refer to (New York Stock Exchange, NASD, and American Stock Exchange) do not contain empowering language equivalent to the AAA provision.

Since even minor variations in language will influence the interpretation of agreements, no universal rule as to the effect of choice of law clauses is possible. It is beyond dispute that the parties are free to decide for themselves what powers and procedures, as well as what substantive rules, will govern the arbitration of their disputes. *Volt v. Stanford*, *supra*. This Court could not announce, for example, a universal rule that "choice of law clauses shall not be deemed to apply to remedies," because the terms of contracts inevitably differ and the question in every such contract case will remain, "What did the parties agree to under the particular terms of this arbitration agreement?" Accordingly, review by this Court is unlikely to achieve uniformity in the future course of decisions.

Since this Court cannot act generally as a reviewing court for particular contract interpretations made by lower courts, the problem presented by this case and others involving similar contracts is best left for resolution by the lower courts on a case by case basis. As the Court stated in *Volt*, "the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review." 489 U.S. at 474, 103 L. Ed. 2d at 497. The present case does not call for an exception. To the contrary, the decision of the Seventh Circuit rests squarely on the authority of *Volt*:

> There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate. Interpreting a choice-of-law clause to make applicable state rules governing the conduct of arbitration . . . simply

does not offend the rule of liberal construction set forth in *Moses H. Cone*, nor does it offend any other policy embodied in the FAA. (489 U.S. at 476, 103 L. Ed. 2d at 498.).

## IV.

## THE SECOND QUESTION PRESENTED IS MERITLESS

Petitioners' second Question Presented appears to be intended to seek review of the Court of Appeals' affirmance of the district court's ruling denying petitioners' request for a trial in the district court to determine punitive damages. *See* Pet. 33. The ruling was plainly correct, both on the ground briefly stated by the Court of Appeals (20 F.3d at 718, Pet. App. 21) and on the additional ground relied on by the district court. Pet. App. 41-43. The Court of Appeals ruled that under the arbitration agreement itself petitioners were entitled only to the damages available in arbitration. The district court had ruled, in addition, that there is no separate cause of action for punitive damages under either New York or Illinois law.

Petitioners argue that the denial of a judicial trial on punitive damages was an improper finding of "waiver." This Court rejected a similar argument in *Volt v. Stanford Univ.*, *supra*. *See* 489 U.S. at 474-75. The argument misconceives the nature of the lower courts' holdings. Petitioners had no "right" to punitive damages; they had only the rights available under the arbitration agreement. Thus, the "waiver" argument adds nothing to petitioners' arguments concerning the correct interpretation of the agreement. Rather, the novel rule suggested by petitioners, that a second substantive hearing be conducted in court to resolve their demand for punitive damages, would eviscerate the central purpose of arbitration—to accomplish the expeditious and efficient resolution of disputes.



## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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*Respondents.*

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## REPLY BRIEF FOR PETITIONERS

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On Petition for Writ of Certiorari to the
United States Court of Appeals
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# REPLY BRIEF FOR PETITIONERS

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## ARGUMENT

### I.

### THIS CASE PRESENTS AN IDEAL OPPORTUNITY FOR THIS COURT TO RESOLVE ISSUES OF SIGNIFICANT IMPACT OVER WHICH A CLEAR SPLIT OF AUTHORITY AMONG THE CIRCUITS CONTINUES TO DEVELOP.

(Reply to Resp. Br., Pt. I, pp. 1-2).

Respondents assert that because this Court has previously declined review of the issues presented here, it should continue to do so, citing this Court's denial of *certiorari* in *J. Alexander Securities, Inc. v. Mendez,* 17 Cal.App. 4th 1083, 21 Cal.Rptr.2d 826 (Cal.Ct.App. 1993), *cert. denied,* ____ U.S. ____, 114 S.Ct. 2182 (June 6, 1994) (O'Connor, J. and Rehnquist, J., dissenting), and *Lee v. Chica,* 983 F.2d 883 (8th Cir. 1993), *cert. denied,* ____ U.S. ____, 114 S.Ct. 287, 126 L.Ed.2d 237 (October 4, 1993). Significantly, this argument fails to address the fact that in both *Mendez* and

*Lee*, the lower courts affirmed arbitral awards of punitive damages, and this Court's determination to decline review left those decisions in place. In this case, this Court's decision to decline review would have the opposite effect, and would essentially affirm a decision vacating an arbitral award of punitive damages based on a choice of law provision.

Further, respondents overlook that what has come to pass is precisely the problem predicted by the justices who dissented from the denial of *certiorari* in *Mendez*. As stated by respondents, the decision of the Seventh Circuit in this case had been decided at the time *certiorari* was denied in *Mendez*, and, in fact, was cited by the dissenting justices as part of the growing body of conflicting



decisions compelling the granting of *certiorari*. The decision in *Mendez*, a decision of the California state appellate court, however, did not itself contribute to the split of authority among the federal Courts of Appeal. Accordingly, the granting of *certiorari* in that case, particularly in light to the pendency of this case, would have constituted an attempt to resolve a conflict among the Circuits in the context of a state court case.

Also, when *certiorari* was denied in *Lee*, the decision of the Eighth Circuit in that case was consistent with the prior decisions of the First, Ninth and Eleventh Circuits, with the only contrary decisions having been previously issued by the Second Circuit. As set forth fully in the Petition For Writ Of Certiorari, the

decision of the Seventh Circuit in this case intensifies the split of authority among the Circuits, with a total of six Circuits having addressed the issue and two finding arbitral awards of punitive damages unenforceable in light of choice of law provisions and four having reached the contrary determination and having upheld awards of punitive damages.

Respondents also suggest that the decisions of the First, Second, Seventh, Eighth, Ninth and Eleventh Circuits, as well as the decision of the California Court of Appeal in *Mendez*, "do not reflect significant disparities in their views as to the requirements of the Federal Arbitration Act" but instead merely reflect "varying interpretations of different contractual language." (Resp. Br., p. 1). As discussed *infra* (at pp.



10-14), however, respondents' argument is a fruitless attempt to reconcile patently contrasting and inconsistent decisions with regard to an issue which is not governed by fact-specific considerations related to the particular contract language involved.

## II.

**PETITIONERS' STATEMENT OF THE FIRST QUESTION PRESENTED FOR THIS COURT'S REVIEW IS CORRECT; THE SEVENTH CIRCUIT'S DECISION CLEARLY SUBORDINATES THE FAA AND THE POLICIES WHICH IT EMBODIES TO NEW YORK STATE LAW, THE LAW OF THE STATE NAMED IN THE CHOICE OF LAW PROVISION CONTAINED IN THE PARTIES' CONTRACT.**

(Reply to Resp. Br., Pt. II, pp. 2-3).

Respondents assert that in formulating the first issue presented for this Court's review, petitioners have "significantly misstated the holding of the Seventh Circuit" and that that error "invalidates petitioners' arguments for

review." (Resp. Br., p. 2). In support of this contention, respondents state that the Seventh Circuit's decision expressly acknowledges that the FAA governs and recognizes the liberal federal policy favoring arbitration agreements which requires that all doubts concerning the scope of arbitrable issues be resolved in favor of arbitration. Respondents' contentions, however, ignore the fact that, notwithstanding the Seventh Circuit's superficial acknowledgement of these principles, both the import of its decision, and the analysis used to reach that decision, clearly contravene the FAA and the policies which it embodies in preference to the New York state rule against arbitral awards of punitive damages.



Further, when confronted with the same issue presented in this case, in upholding arbitral awards of punitive damages, the First, Eighth, Ninth and Eleventh Circuits have framed the issue as a question of whether state or federal law applies. For example, in *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062 (9th Cir. 1991), stated:

> In this case it is clear that federal rules, rather than New York state rules apply. The Supreme Court has said time and time again that issues of arbitrability in cases subject to the act are governed by federal law. *Todd*, 943 F.2d at 1062.

Similarly, in *Lee*, where the arbitration agreement at issue included a Minnesota choice of law provision, the Eighth Circuit stated:

> Even if we accepted as valid [defendant's] argument that under state law the parties did not agree to arbitrate

> punitive damages, it would not be dispositive of this case. This case is governed by federal law. *Lee*, 983 F.2d at 888. [Citations omitted.]

See also *Raytheon v. Automated Business Systems, Inc.*, 882 F.2d 6, 11, n. 5 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988). In each of these cases, the Courts of Appeal found that federal law, rather than the law of a state named in a choice of law provision controlled and, in light of that determination, upheld arbitral awards of punitive damages.

Respondents' reliance on the Seventh Circuit's more recent decision in *Baravati v. Josephthal, Lyon & Ross Inc.*, No. 93-3647 (7th Cir., July 1, 1994), as somehow rehabilitating its decision in this case is unavailing. (A copy of the Seventh Circuit's decision in *Baravati* is appended



hereto.) That decision does not purport to overrule the decision in this case but seeks, *ex post facto*, to excuse the Seventh Circuit's refusal to follow and apply the FAA in preference to the law of a state named in a choice of law provision and, unsuccessfully, to reconcile its decision in this case with the FAA and the policies which it embodies. If anything, the Seventh Circuit's *dicta* discussion of *Mastrobuono* in *Baravati*, a case where the arbitration agreement at issue did not contain a choice of law provision, exacerbates the confusion over how the issue of the arbitrability of punitive damages claims should be addressed where arbitration agreements governed by the FAA contain state choice of law provisions which are asserted to implicitly foreclose arbitral awards of punitive damages.

## III.

## RESPONDENTS' ATTEMPT TO RECONCILE THE DECISION OF THE SEVENTH CIRCUIT IN THIS CASE AND THE DECISION OF THE SECOND CIRCUIT IN *BARBIER*, WITH THE CONTRARY DECISIONS OF THE FIRST, EIGHTH, NINTH AND ELEVENTH CIRCUITS IS UNAVAILING.

In their attempt to obscure the inconsistency of the decisions of the Second and Seventh Circuits with the decisions of the First, Eighth, Ninth and Eleventh Circuits, respondents argue that those decisions do not present "a conflict of legal principle" but rather a matter of different interpretations of different arbitration agreements. (Resp. Br., p. 4). In support of this argument, respondents seek to distinguish the decisions of the First, Eighth, Ninth and Eleventh Circuits on the basis that the arbitration agreements at issue in those cases provided for arbitration under the



rules of the American Arbitration Association.

Contrary to respondents' assertions, the Seventh Circuit itself explicitly acknowledged that its decision in this case conflicts with the decisions of the First, Eighth, Ninth and Eleventh Circuits. (*Mastrobuono v. Shearson, Lehman Hutton, Inc.*, 20 F.3d 713, 718 (7th Cir. 1993); Pet. App., p. 19). Further, respondents' attempts to distinguish this case from those decisions is unavailing, particularly for the reason that the arbitration agreement at issue here does not adopt the AAA rules and that the rules it does refer to "do not contain the empowering language equivalent to the AAA provision." (Resp. Br., p. 5). As the Seventh Circuit acknowledged, the NASD Arbitrator's Manual expressly addresses

the issue of punitive damages, stating, "Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy." In its decision, the Seventh Circuit also noted that the NASD Rules of Fair Practice prohibit any condition that limits the ability of the arbitrators to make any award. Notwithstanding the fact that the NASD rules, like the AAA rules, apparently contemplate the award of punitive damages, the Seventh Circuit concluded that, to the extent that the provisions of the NASD Arbitrator's Manual and the NASD Rules of Fair Practice conflict with New York law, New York law controls.

The Court similarly disregarded the language of the agreement at issue which "does not purport to withhold certain issues from arbitration" but requires



arbitration of all controversies. *Mastrobuono*, 20 F.3d at 718; Pet. App, p. 18. In circumventing this language, the Court created an exception to the federal policy favoring arbitration, stating, "We think the policy favoring arbitrability applies with less force when there are doubts concerning the availability of punitive damages - as opposed to the scope of 'arbitrable issues.'" *Id.*

Given these circumstances, the fact remains, notwithstanding respondents' attempts to discern a basis for distinguishing the Seventh Circuit's decision in this case from the decisions of the First, Eighth, Ninth and Eleventh Circuits, the decisions of the First, Second, Seventh, Eighth, Ninth and Eleventh Circuits are manifestly irreconcilable and the arbitral remedies

available to similarly situated parties who have entered arbitration agreements governed by federal law have come to depend on geographic fortuity. The decisions of those circuits present a clear split of authority on how state choice of law provisions claimed to foreclose arbitral awards of punitive damages are to be read in light of the FAA and federal policy which can only be resolved by this Court.

**IV.**

**THE SEVENTH CIRCUIT CLEARLY ERRED IN ITS DETERMINATION THAT PETITIONERS HAD WAIVED THEIR RIGHT TO PUNITIVE DAMAGES; THE SECOND QUESTION PRESENTED IN THE PETITION FOR WRIT OF *CERTIORARI* IS NOT MERITLESS.**

(Reply to Resp. Br., Pt. IV, p. 6).

Respondents misapprehend the second question stated in the Petition For Writ Of *Certiorari*, stating that that question



"appears to be intended to seek review of the Court of Appeals' affirmance of the district court's ruling denying petitioners' request for a trial in the district court to determine punitive damages." (Resp. Br., p. 6). The point raised is that a waiver requires the voluntary relinquishment of a known right, a relinquishment which, simply put, cannot be inferred from a parties' agreement to a contract provision requiring arbitration of all controversies and a choice of law provision. It is petitioners' assertion, consonant with the definition of waiver promulgated by this Court, that they did not waive their right to recover punitive damages, in whatever forum might be appropriate. The Seventh Circuit glossed over this point, apparently finding that "[b]ecause any condition imposed by New

York law can be found in the books," it was appropriate to find that by accepting a New York choice of law provision, petitioners had "knowingly" surrendered any right to recover punitive damages. *Mastrobuono,* 20 F.3d at 717; Pet. App., p. 14. Such a conclusion is, however, clearly untenable.

Moreover, the Seventh Circuit's decision in this regard directly conflicts with the decision of the Eleventh Circuit in *Bonar, supra*. In *Bonar*, the Eleventh Circuit flatly rejected the argument that the plaintiffs had waived their right to recover punitive damages by signing a customer agreement requiring arbitration of all disputes and a New York choice of law provision. *Bonar*, 835 F.2d at 1387-1388. The Seventh Circuit's incorrect application of the law of waiver, as well



as the conflict between the decision of the Seventh Circuit in this case and the Eleventh Circuit in *Bonar*, further supports the granting of *certiorari*.

**CONCLUSION**

For the foregoing reasons, the Petition For Writ Of Certiorari should be granted.

Respectfully submitted,

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# APPENDIX

In the

# United States Court of Appeals

## For the Seventh Circuit

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No. 93-3647

AHMAD BARAVATI,

*Plaintiff-Appellee,*

*v.*

JOSEPHTHAL, LYON & ROSS, INCORPORATED, and PETER SHEIB,

*Defendants-Appellants.*

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Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 93 C 338—**George M. Marovich,** *Judge.*

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ARGUED APRIL 7, 1994—DECIDED JULY 1, 1994

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Before POSNER, *Chief Judge*, BAUER, *Circuit Judge*, and TINDER, *District Judge.**

POSNER, *Chief Judge.* Ahmad Baravati was employed as a broker in the Chicago office of Josephthal, Lyon & Ross, Inc. (JLR), a New York securities firm that is a member of the National Association of Securities Dealers. JLR fired Baravati. The NASD requires that whenever a broker is terminated, the member firm that employed him must fill out and submit to the association a termina-

---

* Hon. John Daniel Tinder of the Southern District of Indiana.

tion notice form (form U-5), which the NASD retains and makes available to any member who wants information about the broker, perhaps because he has applied for a job with the member. The form asks the reason for the termination. The reason JLR listed was that Baravati was "under investigation by [JLR] for the fraudulent and wrongful taking of firm property in the amount of $7,650.25." The parties agree that Baravati's contract with JLR required disputes, tortious as well as contractual, arising under the contract to be arbitrated in accordance with the NASD's Code of Arbitration Procedure. (Submission of disputes to arbitration is now a required term in employment contracts with members of NASD. *Kresock v. Bankers Trust Co.*, 21 F.3d 176, 178-79 (7th Cir. 1994).) Contending that the reason stated in the U-5 for firing him was false and defamatory—that in fact he had been fired in retaliation for blowing the whistle to the SEC about fraud committed by JLR on its customers—Baravati, like a number of similarly situated brokers lately (see Edward Felsenthal, "Filings about Brokers' Departures Made by Firms Spark Libel Suits," *Wall St. J.*, April 14, 1994, p. B2), invoked the arbitral process. The arbitrators found that he had been defamed and awarded him $60,000 in compensatory damages and $120,000 in punitive damages. Baravati went to district court to enforce the award, 9 U.S.C. § 9, and won. 834 F. Supp. 1023 (N.D. Ill. 1993). JLR appeals.

Judicial review of arbitration awards is tightly limited; perhaps it ought not be called "review" at all. By including an arbitration clause in their contract the parties agree to submit disputes arising out of the contract to a nonjudicial forum, and we do not allow the disappointed party to bring his dispute into court by the back door, arguing that he is entitled to appellate review of the arbitrators' decision. *United Paperworkers International Union v. Misco, Inc.*, 484 U.S. 29, 36 (1987); *Chicago Typographical Union v. Chicago Sun-Times, Inc.*, 935 F.2d 1501, 1504-06 (7th Cir. 1991); *Brotherhood of Locomotive Engineers v. Atchison, Topeka & Santa Fe Ry.*, 768 F.2d 914, 921 (7th



Cir. 1985). There are, nevertheless, limited grounds on which an arbitral award can be set aside, such as that the arbitrators "exceeded their powers." 9 U.S.C. § 10(a)(4).

A number of courts, including our own, have said that they can set aside arbitral awards if the arbitrators exhibited a "manifest disregard of the law." *Health Services Management Corp. v. Hughes*, 975 F.2d 1253, 1267 (7th Cir. 1992); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1060 (9th Cir. 1991); Note, "Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the 'Manifest Disregard' of the Law Standard," 27 *Ind. L. Rev.* 241, 251-54 (1993). Two courts, however, have declined to adopt this formula, *Ainsworth v. Skurnick*, 960 F.2d 939, 940-41 (11th Cir. 1992) (per curiam); *Stroh Container Co. v. Delphi Industries, Inc.*, 783 F.2d 743, 750 (8th Cir. 1986), though without rejecting it. Two have criticized it. *Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 1410, 1412-13 (11th Cir. 1990); *I/S Stavborg v. National Metal Converters, Inc.*, 500 F.2d 424, 430-31 (2d Cir. 1974). The criticisms are marshaled and endorsed in the excellent student note in the *Indiana Law Review*. The formula is dictum, as no one has found a case where, had it not been intoned, the result would have been different. It originated in *Wilko v. Swan*, 346 U.S. 427, 436-37 (1953) (see *Drayer v. Krasner*, 572 F.2d 348, 352 (2d Cir. 1978) (Friendly, J.))—a case the Supreme Court first criticized for its mistrust of arbitration and confined to its narrowest possible holding, *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 231-34 (1987), and then overruled. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 485 (1989). Created *ex nihilo* to be a nonstatutory ground for setting aside arbitral awards, the *Wilko* formula reflects precisely that mistrust of arbitration for which the Court in its two *Shearson/American* opinions criticized *Wilko*. We can understand neither the need for the formula nor the role that it plays in judicial review of arbitration (we suspect none—that it is just words). If it is meant to smuggle review for clear error in by the back door, it is inconsistent with the entire modern law of arbitration. If it is in-

tended to be synonymous with the statutory formula that it most nearly resembles—whether the arbitrators "exceeded their powers"—it is superfluous and confusing. There is enough confusion in the law. The grounds for setting aside arbitration awards are exhaustively stated in the statute. Now that *Wilko* is history, there is no reason to continue to echo its gratuitous attempt at nonstatutory supplementation. So it will be enough in this case to consider whether the arbitrators exceeded their powers.

JLR makes two points (the third, that Baravati waived his right to complain about being defamed, is frivolous and need not be discussed). The first is that under the law of Illinois the contents of the U-5 form that JLR filled out and submitted to the NASD are, like a pleading, testimony, exhibit, or opinion, absolutely privileged as a communication made in a judicial or quasi-judicial proceeding. The law of *Illinois*? Confirmation of the arbitrators' award was sought under Title 9 of the U.S. Code, the Federal Arbitration Act. Yet one might think that in a case such as this, where the basis of federal jurisdiction is diversity of citizenship rather than the existence of a federal question (as it would be if, for example, an arbitration award based on a collective bargaining contract subject to section 301 of the Taft-Hartley Act, 29 U.S.C. § 185, were sought to be enforced), substantial constitutional questions would arise if the federal courts tried to create a body of substantive law to be applied by the arbitrators. *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938), holds that the conferral by Article III of the Constitution of diversity jurisdiction on the federal courts does not authorize them to create substantive law to govern the disputes arising under that jurisdiction. The Federal Arbitration Act, however, is limited to diversity cases *that affect interstate commerce*, 9 U.S.C. §§ 1, 2, a basis of federal lawmaking jurisdiction. *Bernhardt v. Polygraphic Co.*, 350 U.S. 198, 201-02 (1956); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405 (1967). The Act therefore can, and the Supreme Court has held that it does, authorize the federal courts



to create a federal substantive law of arbitration to apply in cases under the Act. *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24-25 and n. 32 (1983); *Southland Corp. v. Keating*, 465 U.S. 1, 11-16 (1984).

A standard way in which federal courts make federal common law is by adopting the law of the state whose law would govern in the absence of federal law, subject to the implicit proviso that the adopted state law be consistent with federal policy. The states have richer bodies of common law than the federal courts do and it is desirable to minimize the number of different legal rules to which people are subject. *Powers v. United States Postal Service*, 671 F.2d 1041 (7th Cir. 1982). So if we started with federal common law we might end up with Illinois law after all. But there is a more direct route. This case is unusual because the arbitrators, rather than being called upon to interpret a contract, their usual function, were called upon to determine whether one party had defamed the other. (There is, as we said, no contention that they were not empowered by the parties' contract to do so.) Defamation is an area of state law, and the various defamation privileges are an integral part of the law of defamation. It would be surprising if in authorizing the arbitration of their disputes the parties had intended the arbitrators to *make up* a law of defamation to apply to those disputes. More likely they were expected to apply the defamation law of some state, and Illinois is as plausible a candidate as any, since Baravati worked in JLR's Chicago office. So let us apply the Illinois law of privilege.

That is easier said than done. *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 516-17 (2d Cir. 1991), rejected a claim of privilege on facts similar to ours, but it was not an Illinois case—there is no Illinois case on the question—and the court's brief discussion suggests that the arbitrators were correctly applying New York law. It might seem obvious and therefore in need of no authority that

arbitrators may not disregard established legal privileges and immunities. Privileges and immunities limit the powers of adjudicative bodies because of concerns believed to override the interest in allowing such bodies to consider all probative evidence and render decisions that vindicate the rights of injured parties. The absolute privilege from liability for defamation based on judicial and quasi-judicial communications is closely related to the absolute immunity of judges, legislatures, prosecutors, and witnesses; in fact it overlaps all those immunities. *Briscoe v. LaHue*, 460 U.S. 325, 330-36 (1983). Without it the collection and examination of evidence would be hampered, because lawyers, litigants, witnesses, and judges would be fearful of being sued for defamation on the basis of their submissions, arguments, testimony, or rulings. The absolute privilege is recognized in Illinois, *McGrew v. Heinold Commodities, Inc.*, 497 N.E.2d 424, 432 (Ill. App. 1986), and was extended to quasi-judicial bodies in *Allen v. Ali*, 435 N.E.2d 167 (Ill. App. 1982), which involved the state supreme court's attorney disciplinary body. And yet it is far from plain that to allow arbitrators, alone of dispute resolvers, to disregard the privilege would undermine it. The privilege is, we may assume, waivable (other privileges are, and we cannot see why this one should be an exception, though we can find no cases on the question), and consent to arbitration could be thought a waiver if it is the practice of arbitrators not to honor the absolute privilege. The parties have not told us whether it is or not.

We need not wrestle this issue to the ground. JLR could not in any event assert the absolute privilege under the facts of this case. This is true even though federal securities law gives NASD quasi-judicial responsibilities. Those laws impose duties of self-regulation on stock exchanges and on, what is functionally the same thing, dealer associations in the over-the-counter markets. 15 U.S.C. § 78o-3; *SEC v. Waco Financial, Inc.*, 751 F.2d 831, 832 (6th Cir. 1985); Louis Loss, *Fundamentals of Securities Regulation* 620-24 (2d ed. 1988). We may assume that when the NASD



in the discharge of these duties investigates or adjudicates or imposes sanctions with respect to suspected violations of the rules that it enforces, the participants in those proceedings are entitled to the absolute privilege to the same extent as in judicial proceedings. Cf. *Kalish v. Illinois Education Ass'n*, 510 N.E.2d 1103 (Ill. App. 1987). But the submission of a U-5 form and its transmission (upon request) to members of the NASD are not stages in the association's quasi-judicial regulatory process. In the first instance they are the means which the NASD administers an employment clearinghouse. By revealing the reason for the termination the form gives other members of the association potentially valuable information concerning the availability and suitability of potential employees. This information service is remote from a judicial proceeding; and while a U-5 can trigger an investigation or even serve as evidence in a disciplinary proceeding against a member or broker, any item of information could do that. To insulate the members from liability for the contents of their U-5s would be tantamount to allowing a member of the NASD to blackball a former employee from employment throughout the large sector of the industry that the membership of the association constitutes. (About half of all registered broker-dealers belong to it.)

We must not overdramatize. The employee can seek to clear his name by asking the NASD to investigate or by invoking the arbitral process, as Baravati did; in fact, the defendants told us without contradiction, Baravati found employment with another member firm; and securities firms will be reluctant to give reasons for a termination that might scare their clients, although we do not know to what extent U-5s circulate outside the brokerage houses themselves. So the sky would not fall if the privilege were allowed to bar the kind of relief sought by Baravati. What is more, since the members are *required* to state the reason for termination on the U-5, denial of the privilege puts them in a hard place, where if they state a reason discreditable to the employee they may be sued for libel while if they lie about the reason they will be

violating the association's rules. *NASD Manual* ¶ 1153 (C.C.H. 1993) (art. IV, § 3(a) of NASD's by-laws). But it is only the *absolute* privilege that is in issue in this case. All concede that, just as in the case of an employer's character reference, the firm has a qualified privilege to defame the employee on the U-5, a privilege forfeited (under Illinois law) only if the firm knows or is reckless in failing to discover that it is defaming him falsely. *Mittelman v. Witous*, 552 N.E.2d 973, 980-81 (Ill. 1989). An absolute privilege is strong medicine, and we do not think that JLR has made a case for extending it beyond the judicial and quasi-judicial context and into the termination notice, even if the privilege is not waived in advance by consent to have disputes resolved by arbitrators rather than by courts.

JLR's second argument is that the arbitrators exceeded their powers in awarding punitive damages. NASD's Code of Arbitration Procedure, incorporated by reference in the contract between Baravati and JLR, requires arbitrators to provide "a summary of . . . the damages and other relief awarded," but contains no other reference to the arbitrators' remedial powers. *Mastrobuono v. Shearson Lehman Hutton Inc.*, 20 F.3d 713 (7th Cir. 1994), holds that if the body of law that the parties agreed would govern their disputes forbids arbitral awards of punitive damages in that class of case, a federal court cannot confirm the award. The contract specified New York law, which forbade arbitral awards of punitive damages in the type of dispute that had arisen and had been submitted to arbitration, so we held that the arbitrators' award of punitive damages could not be confirmed.

*Mastrobuono* put us in conflict with four other circuits, which hold that such a choice of law designation does not override the power of arbitrators to award punitive damages, provided the rules that the parties have agreed are to govern the arbitration authorize the arbitrator, implicitly or explicitly, to award such damages. *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988); *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, *supra*, 943 F.2d at 1061-63; *Lee v. Chica*, 983 F.2d 883, 887-88 (8th Cir. 1993); see also *J. Alexander Securities, Inc. v. Mendez*, 21 Cal. Rptr. 2d 826 (App. 1993), and Justice O'Connor's dissent from the denial of certiorari in *Mendez*, 62 U.S.L.W. 3575 (U.S. June 6, 1994). The rules of the American Arbitration Association, which were applicable in those cases, authorize arbitrators to award "any remedy which [is] just and equitable and within the scope of the agreement," and this was deemed authorization enough for the awarding of punitive damages. These courts, however, would enforce a provision in an arbitration clause that *forbade* the arbitrator to award punitive damages; and if, as we thought was the situation in *Mastrobuono*, the parties do the same thing by invoking a body of law that contains such a prohibition, there would be no greater reason to refuse to honor their choice. Indeed, short of authorizing trial by battle or ordeal or, more doubtfully, by a panel of three monkeys, parties can stipulate to whatever procedures they want to govern the arbitration of their disputes; parties are as free to specify idiosyncratic terms of arbitration as they are to specify any other terms in their contract. Cf. *Rashid v. Schenck Construction Co.*, 438 S.E.2d 543, 547 (W. Va. 1993); *Perini Corp. v. Greate Bay Hotel & Casino, Inc.*, 610 A.2d 364, 369 (N.J. 1992), overruled on other grounds in *Tretina Printing, Inc. v. Fitzpatrick & Associates, Inc.*, 640 A.2d 788 (N.J. 1994); *Astoria Medical Group v. Health Ins. Plan*, 182 N.E.2d 85, 87 (N.Y. 1962). For that matter, parties to adjudication have considerable power to vary the normal procedures, *DDI Seamless Cylinder Int'l, Inc. v. General Fire Extinguisher Corp.*, 14 F.3d 1163 (7th Cir. 1994), and surely can stipulate that punitive damages will not be awarded. The difference between *Mastrobuono* and the contrary decisions is simply a difference over the proper interpretation of the choice of law clause read in light of the parties' agreement to have their disputes arbitrated under rules that allow for the award of punitive damages. The other circuits believe that these provisions are best reconciled by confining the choice of law provision to sub-

stantive matters, allowing the arbitrators free rein in procedural and remedial matters.

This disagreement does not bear directly on the present case, however, where there is neither a choice of law provision nor a provision in the governing arbitration rules concerning the scope of the arbitrators' remedial powers. We have suggested that if the court asked to enforce (or set aside) the arbitrators' award had occasion to apply federal common law to some dispute (say over arbitrability), it might well look to Illinois law for guidance. That is a different question from whether the *arbitrators* were required to look to Illinois law for guidance or remedies. The contract involved in the *Mastrobuono* case *told* the arbitrators to apply New York law, and the question was whether this meant remedial (as we thought, and the other circuits do not) as well as substantive law. There is no similar directive in this case. We hesitate to infer one. It is commonplace to leave the arbitrators pretty much at large in the formulation of remedies, just as in the formulation of the principles of contract interpretation. *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 597 (1960); *Miller Brewing Co. v. Brewery Workers*, 739 F.2d 1159, 1163 (7th Cir. 1984); *Chameleon Dental Products, Inc. v. Jackson*, 925 F.2d 223, 225 (7th Cir. 1991); *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*, 776 F.2d 269 (11th Cir. 1985) (per curiam). So far as appears, that is what the parties intended here. No negative inference can be drawn from the failure of the NASD's Code of Arbitration Procedure to say anything about the scope of the arbitrators' powers. Silence implies—given the tradition of allowing arbitrators flexible remedial discretion—the absence of categorical limitations. Since that is the norm, we assume that the parties would have said something in the arbitration clause had they wanted to depart from it.

Occasional statements that punitive damages are disfavored in arbitration, see, e.g., *Miller Brewing Co. v. Brewery Workers*, *supra*, 739 F.2d at 1164, must be read in context. Most arbitrations concern contract interpretation, and it is untraditional and still infrequent to award



punitive damages for breach of contract. "[T]he traditional unavailability of punitive or exemplary damages in arbitration . . . can be traced to the common law notion that punitive damages are not available in the standard action for breach of contract." Marvin F. Hill, Jr. & Anthony V. Sinicropi, *Remedies in Arbitration* 436 (2d ed. 1991). Here we have the unusual case of a tort arbitration, and punitive damages are commonly awarded for certain torts, including defamation subject to constitutional limitations not here invoked.

It remains to consider whether Illinois has a policy limiting the award of punitive damages by arbitrators that we should adopt as part of the federal common law of arbitration applicable to disputes that would be governed by Illinois law were they not within the purview of the Federal Arbitration Act. *Fahnestock & Co. v. Waltman*, *supra*, held that New York's common law rule forbidding arbitrators to award punitive damages governed in an arbitration under the Federal Arbitration Act when, as in the present case, the arbitration was not being conducted under rules authorizing such relief. There was no question that that *was* New York's rule. We have only one Illinois decision, *Edward Electric Co. v. Automation, Inc.*, 593 N.E.2d 833, 842-43 (Ill. App. 1992); it is based entirely on the New York rule; and it has been narrowly interpreted in the only case to cite it. *Board of Education v. Illinois Educational Labor Relations Board*, 617 N.E.2d 269, 277 n. 4 (Ill. App. 1993). *Edward* holds that arbitrators may not award punitive damages unless the contract authorizing arbitration expressly authorizes such awards. It did not do so here. *Edward* is a contract case, not a tort case, and we cannot be certain that the outcome would have been the same had it been a case in which punitive damages would have been a normal remedy for a court to award; for if a court, why not a panel of arbitrators, if that was the parties' own preferred tribunal? More fundamentally, we do not think that a state policy based, as the rule announced in the *Edward* decision is, on mistrust of arbitrators is a plausible candidate for incorporation

into the federal common law of arbitration. The Federal Arbitration Act proceeds on the opposite premise, as the *Shearson/American* cases make clear. Close questions concerning the interpretation of the scope of the powers authorized to the arbitrator are resolved in favor of those powers. That is the teaching of the anti-*Mastrobuono* cases that we cited earlier, and the disagreement between those cases and *Mastrobuono* is not over the principle but over its application. Even if *Edward* is a correct statement of Illinois law, it is not a correct interpretation of the Federal Arbitration Act. In arbitrations governed by that Act, arbitrators are authorized to award punitive damages unless the parties have withdrawn that power, which they have not done here. *J. Alexander Securities, Inc. v. Mendez, supra*, 21 Cal. Rptr. 2d at 831.

Although *Fahnestock* is distinguishable from the present case, we will not coyly attempt to conceal our disagreement with it. Not only is a rule forbidding arbitrators to award punitive damages an implausible candidate for incorporation into the federal common law of arbitration, but *Fahnestock* appears to hold that state common law of arbitration governs cases under the Federal Arbitration Act unless the parties have expressed their intentions not to be bound by it, as by subscribing to rules of arbitration that authorize the award of relief barred by the common law. At that point, the court seems to have thought, federal common law would spring back into place. We don't agree. State common law hostile to arbitration is preempted by federal common law friendly to it.

Of course if the Illinois law of *defamation* did not authorize the award of punitive damages in a case such as this, the arbitrators would be bound if we are correct that the parties' agreement was that the arbitrators would apply the law of some state, plausibly Illinois's, to tort claims arising out of the employment relation. That is not argued. The argument is that Illinois has some special rule concerning the award of punitive damages by arbitrators



in any class of case. Such a rule, if it exists, is preempted by the Federal Arbitration Act.

The arbitrators' award was lawful, and the judgment of the district court is therefore

AFFIRMED.

A true Copy:

Teste:

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*Clerk of the United States Court of Appeals for the Seventh Circuit*

Supreme Court, U.S.
FILED
NOV 16 1994
OFFICE OF THE CLERK

No. 94-18

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1994

**Antonio C. Mastrobuono and Diana G. Mastrobuono,**

*Petitioners,*

v.

**Shearson Lehman Hutton Inc., a corporation, and Nick DiMinico,**

*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## JOINT APPENDIX

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**PETITION FOR CERTIORARI FILED JUNE 28, 1994**
**CERTIORARI GRANTED OCTOBER 7, 1994**

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## LIST OF OMITTED ITEMS

The following items have been omitted in printing this joint appendix because they appear on the following pages in the Appendix to the Petition for Writ of Certiorari:


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| Opinion of the United States Court of Appeals for the Seventh Circuit, dated March 30, 1994 ..... | App. 1-27 |
| Order of the United States District Court for the Northern District of Illinois, dated February 9, 1993 ..... | App. 28-43 |
| Client's Agreement, paragraph 13 ..... | App. 44 |

No. 94-18

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1994

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**Antonio C. Mastrobuono and Diana G. Mastrobuono,**

*Petitioners,*

v.

**Shearson Lehman Hutton Inc., a corporation, and Nick DiMinico,**

*Respondents.*

---

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## JOINT APPENDIX

## CHRONOLOGICAL LIST OF RELEVANT DOCKET ENTRIES

United States District Court for the Northern District of Illinois,

Civil Action No. 89 C 0773

*Date* *Filing/Proceeding*

01/30/89—Complaint (Jury Demand).

* * * *

04/11/89—Plaintiffs' Memorandum in opposition to defendants' motion to stay proceedings and compel arbitration.

* * * *

04/14/89—Defendants' Motion to stay proceedings and to compel arbitration.

04/14/89—Defendants' Memorandum in support of motion to stay proceedings and to compel arbitration.

* * * *

07/14/89—First Amended Complaint.

* * * *

08/02/89—Defendants' Supplemental Motion to stay proceedings and to compel arbitration.

08/02/89—Defendants' Memorandum in support of supplemental motion to stay proceedings and to compel arbitration.

08/02/89—Minute Order of 08/02/89: Defendants' motion to stay proceedings and to compel arbitration is granted.

* * * *

*Date* *Filing/Proceeding*

11/05/92—Motion by defendants Shearson Lehman Hutton Inc. and Nick DiMinico to partially vacate arbitration award.

11/05/92—Affidavit of Thomas M. Knepper (with exhibits A-D thereto) submitted in support of defendants' motion to partially vacate arbitration award.

11/05/92—Memorandum of law (with exhibit A thereto) by defendants Shearson Lehman Hutton Inc. and Nick DiMinico in support of motion to partially vacate arbitration award.

* * * *

12/07/92—Memorandum by plaintiffs (with exhibits A-H thereto) in opposition to defendants' vacatur petition.

12/11/92—Motion by plaintiffs (with exhibits) for confirmation of arbitration award and for entry of judgment thereon; or in the alternative, to set a date for trial on amount of punitive damages to be awarded on arbitrators' finding that plaintiffs are entitled to punitive damages; or in the further alternative, to set a date for trial on plaintiffs' pending claims for punitive damages for defendants' negligence, fraud, breach of fiduciary duty and violations of the Illinois and Texas consumer fraud acts.

* * * *

12/30/92—Reply Memorandum of law by defendants Shearson Lehman Hutton Inc. and Nick DiMinico in support of motion to partially vacate arbitration award.

* * * *



*Date* *Filing/Proceeding*

02/06/93—Minute Order of 02/06/93: Plaintiffs' motion for confirmation of arbitration award and entry of judgment thereon; or in the alternative, to set a date for trial on amount of punitive damages to be awarded on arbitrators' finding that plaintiffs are entitled to punitive damages; or in the further alternative, to set a date for trial on plaintiffs' pending claims for punitive damages for defendants' negligence, fraud, breach of fiduciary duty and violations of the Illinois and Texas consumer fraud acts is denied.

02/09/93—Order: Defendants' motion to partially vacate arbitration award is granted.

02/09/93—Minute Order of 02/09/93: Defendants' motion to partially vacate arbitration award is granted.

03/08/93—Notice of Appeal by plaintiffs Diana G. Mastrobuono and Antonio C. Mastrobuono from motion Minute Order dated 2/9/93, from motion Order dated 2/9/93 and from motion Minute Order dated 2/6/93.

* * * *

04/21/94—Certified Copy of Order of the United States Court of Appeals for the Seventh Circuit, entered 3/30/94, affirming the Judgment of the District Court and awarding costs to the appellees.

04/21/94—Opinion of the United States Court of Appeals for the Seventh Circuit, decided 3/30/94.

## CHRONOLOGICAL LIST OF RELEVANT DOCKET ENTRIES

United States Court of Appeals
for the Seventh Circuit,

No. 93-1581

*Date* *Filing/Proceeding*

* * * *

04/19/93—Plaintiffs-Appellants' Brief.

05/19/93—Defendants-Appellees' Brief.

* * * *

06/07/93—Plaintiffs-Appellants' Reply Brief.

* * * *

12/28/93—Plaintiffs-Appellants' Citation Of Additional Authority.

03/30/94—Opinion of the Court, affirming decision of the District Court.

03/30/94—Order of final judgment; affirmed; costs awarded to appellees.

* * * *

(6)

Supreme Court, U.S.
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No. 94-18

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1994

**Antonio C. Mastrobuono and Diana G. Mastrobuono,**

*Petitioners,*

v.

**Shearson Lehman Hutton Inc., a corporation, and Nick DiMinico,**

*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## BRIEF FOR PETITIONERS

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85 pp

## QUESTIONS PRESENTED

1. Whether the Seventh Circuit erred in holding that the law of a state named in a choice-of-law provision, rather than the Federal Arbitration Act, governs the arbitrability of a claim for punitive damages arising out of a contract which evidences a transaction involving commerce and which contains a comprehensive arbitration clause.

2. Whether the Seventh Circuit erred in holding that a party to a contract containing a comprehensive arbitration clause waives the right to recover punitive damages in any forum where the contract also includes a provision that the agreement is governed by the law of a state which does not permit arbitral awards of punitive damages.

## LIST OF PARTIES

Petitioners:

Antonio C. Mastrobuono

Diana G. Mastrobuono

Respondents:

Lehman Brothers Inc. (Lehman Brothers Inc. is the successor corporation to the corporation that was formerly known as Shearson Lehman Hutton Inc.).[1]

Nick DiMinico

Richard F. Benzer and Mark Stevenson who were previously named as Respondents in the caption of the Petition For Writ Of Certiorari, Respondents' Brief In Opposition and Reply Brief For Petitioners, appeared in the caption of

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[1] Pursuant to Supreme Court Rule 29.1, the Court is advised that the parent company of Lehman Brothers Inc. is Lehman Brothers Holdings Inc. Lehman Brothers Inc. has no subsidiaries except those which are wholly owned subsidiaries.



the case in the proceedings before the Court of Appeals but were not parties to those proceedings and are not parties herein. Accordingly, they have been eliminated from the caption of the case in this Court.

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**IN THE**
**SUPREME COURT OF THE UNITED STATES**

**October Term, 1994**

---

**Antonio C. Mastrobuono and Diana G. Mastrobuono,**

**Petitioners,**

**v.**

**SHEARSON LEHMAN HUTTON INC., a corporation, and Nick DiMinico,**

**Respondents.**

---

**On Writ of Certiorari to the United States Court of Appeals For the Seventh Circuit**

---

# BRIEF FOR PETITIONERS

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## CITATIONS TO OPINIONS BELOW

The decision of the Court of Appeals for the Seventh Circuit (hereinafter the "Seventh Circuit") is reported at 20 F.3d

713 (1994), and is reprinted in full in the Appendix to the Petition For Writ Of Certiorari at App. 1 - App. 27.

The Order of the United States District Court for the Northern District of Illinois (the Honorable Charles Norgle) is reported at 812 F.Supp. 845 (N.D. Ill. 1993), and is reprinted in full in the Appendix to the Petition For Writ Of Certiorari at App. 28 - App. 43.

**STATEMENT OF JURISDICTION**

Petitioners seek review of the decision of the Seventh Circuit entered on March 30, 1994, affirming the District Court's Order vacating an arbitral award of punitive damages in favor of petitioners and denying petitioners' motion, in the alternative, for a trial on the amount of petitioners' punitive damages claims to be awarded on the



arbitrators' finding that they were entitled to punitive damages or, in the further alternative, for a trial on the state statutory and common law claims giving rise to petitioners' claim for punitive damages.

Jurisdiction is conferred upon this Court to review the March 30, 1994 judgment of the Seventh Circuit by 28 U.S.C. §1254(1). The Petition For Writ Of Certiorari was timely filed on June 28, 1994 and, on October 7, 1994, this Court granted certiorari.

**STATUTE INVOLVED**

The relevant text of 9 U.S.C. §§ 2, 3, 4 and 10 is set forth in the Appendix hereto at App. 1 - App. 4.

**STATEMENT OF THE CASE**

In October, 1985, respondent Nick DiMinico (hereinafter at times

"DiMinico"), a licensed representative and vice-president of respondent Shearson Lehman Hutton Inc. (hereinafter at times "Shearson"), solicited petitioners, Antonio and Diana Mastrobuono (hereinafter at times "the Mastrobuonos"), to open a securities trading account with Shearson. (Memo. In Opposition to *Vacatur* Petition, pp. 1-2, Docket No. 81). At that time, Antonio Mastrobuono was an assistant professor of Medieval Literature at the University of Illinois at Chicago and his wife, Diana, was an artist and homemaker. DiMinico had been Antonio Mastrobuono's student and had become personal friends of the Mastrobuonos. The Mastrobuonos explained to DiMinico that the money they were giving him to invest represented all of their money and that they intended to use the money to purchase a home in the



Chicago area and to pay for their children's education. In light of this, the money was to be invested with safety and income as the only objectives. (Memo. In Opposition to *Vacatur* Petition, Exhibit D - Amended Statement Of Claim, Docket No. 81; Brief And Appendix Of Appellants, pp. 1-2). In connection with opening their account, the Mastrobuonos executed Shearson's standard form Client's Agreement. (Memo. In Opposition to *Vacatur* Petition, Exhibit A, Docket No. 81).

Paragraph 13 of the Client's Agreement provided, in relevant part:

> This agreement ... shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the

> breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Board of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as I may elect.... (Memo. In Opposition to *Vacatur* Petition, Exhibit A - Client's Agreement, Docket No. 81; Pet. App. at 44).

DiMinico serviced the Mastrobuonos' account and, during the course of his handling of the account, engaged in various forms of misconduct, including unauthorized trading and churning. In 1987, after incurring substantial losses, the Mastrobuonos closed their account. (See Memo. In Opposition to *Vacatur* Petition, Exhibit D - Amended Statement of Claim, and Exhibit E - N.A.S.D. Award, Docket No. 81).

In January, 1989, the Mastrobuonos filed suit in the United States District Court for the Northern District of



Illinois, alleging that Shearson and DiMinico had subjected their account to unauthorized trading, churning and margin exposure. In their Complaint, the Mastrobuonos invoked the jurisdiction of the District Court pursuant to 28 U.S.C. §1331 (federal question) over their claims pursuant to the Securities Exchange Act of 1934 and the Racketeer Influenced and Corrupt Organizations Act ("RICO"), and its pendent (supplemental) jurisdiction over their claims based on the Illinois Securities Law, Illinois Consumer Fraud and Deceptive Business Practices Act and common law claims for breach of contract, breach of fiduciary duty, fraud, misrepresentation, and negligence. In their prayer for relief, the Mastrobuonos sought compensatory damages, attorneys' fees and costs, treble damages under the

RICO claim and punitive damages under the Illinois statutory and common law claims. (Complaint, Docket No. 1).

In April, 1989, respondents moved, pursuant to §§ 3 and 4 of the Federal Arbitration Act (hereinafter "FAA"), to stay the District Court proceedings and to compel arbitration before the National Association of Securities Dealers (hereinafter "NASD"). (Defendants' Motion To Stay Proceedings And To Compel Arbitration, Docket No. 22). The District Court granted the motion. (8/2/89 Minute Order, Docket No. 38).

The Mastrobuonos filed their Statement of Claim on October 20, 1989, and their Amended Statement of Claim on September 16, 1991. (Memo. In Opposition to *Vacatur* Petition, Exhibit E - N.A.S.D. Award, Docket No. 81). In their Amended



Statement Of Claim, the Mastrobuonos stated claims based on violation of the NASD Rules of Fair Practice, SEC Rule 10b-5, §15(c)(1) of the Securities Exchange Act, the Illinois Consumer Fraud Act, the Texas Deceptive Trade Practices-Consumer Protection Act, and common law claims for breach of fiduciary duty and negligence. The Mastrobuonos requested compensatory and punitive damages, as well as treble damages under the Texas Deceptive Trade Practices-Consumer Protection Act. (Memo. In Opposition to *Vacatur* Petition, Exhibit D - Amended Statement of Claim, Docket No. 81). The arbitration hearings took place before a panel of three arbitrators on August 11 and 12, 1992, and September 29, 1992, in Chicago, Illinois. On September 29, 1992, respondents asserted for the first time that the arbitrators lacked the

authority to award punitive damages, submitting their Respondents' Memorandum Regarding Claim For Punitive Damages to the arbitration panel. (Motion to Partially Vacate Arbitration Award, p. 2, para. 4, Docket No. 58; Knepper Affidavit, Exhibit B, Docket No. 59). The Mastrobuonos were given leave to respond and thereafter submitted their Brief In Opposition to Punitive Damages. (Knepper Affidavit, Exhibit C, Docket No. 59).

On October 13, 1992, the arbitrators awarded the Mastrobuonos compensatory damages in the amount of $159,327.00 ($115,274.00 in commissions and $44,053.00 in margin interest) and punitive damages in the amount of $400,000.00. (Memo. In Opposition to *Vacatur* Petition, Exhibit E - N.A.S.D. Award, Docket No. 81).



Respondents did not contest and subsequently paid the compensatory damages award but moved in the District Court, pursuant to 9 U.S.C. §10(a)(4), to vacate the award of punitive damages. Respondents argued that New York law, the law governing the Client's Agreement, prohibits arbitrators from awarding punitive damages. (Motion To Partially Vacate Arbitration Award, Docket No. 58; Memo. of Law in Support of Motion to Partially Vacate Arbitration Award, Docket No. 60). The Mastrobuonos moved for confirmation of the arbitration award or, in the alternative, for a trial on the amount of punitive damages to be awarded on the arbitrators' finding that the Mastrobuonos were entitled to punitive damages or, in the further alternative, for a trial on the state statutory and

common law claims giving rise to their claim for punitive damages. (Motion For Confirmation Of Arbitration Award And Entry Of Judgment Thereon; Or In The Alternative to Set A Date For Trial On Amount Of Punitive Damages to Be Awarded On Arbitrators' Finding That Plaintiffs Are Entitled To Punitive Damages; Or In The Further Alternative To Set A Trial Date On Plaintiffs' Pending Claims For Punitive Damages For Defendants' Negligence, Fraud, Breach Of Fiduciary Duty And Violations Of The Illinois And Texas Consumer Fraud Acts, Docket No. 68). The District Court granted respondents' motion, vacating the punitive damages award, and denied the Mastrobuonos' motion in its entirety. (2/9/93 Order, Docket No. 79; Pet. App. at 28-43).



On appeal, the Seventh Circuit affirmed the decision of the District Court, confirming the District Court's finding that the arbitrators had exceeded their power by awarding punitive damages. (Opinion of the Court of Appeals for the Seventh Circuit, Docket No. 92; Pet. App. at 1-27).

## SUMMARY OF THE ARGUMENT

1. In this case the Seventh Circuit held that by entering into a customer agreement with a securities dealer which contained a New York choice-of-law provision and a comprehensive arbitration clause, the Mastrobuonos had agreed to accept a New York common law rule against arbitral awards of punitive damages and had thereby surrendered any claim for punitive damages. The decisions of this Court, however, have conclusively

established that, with regard to agreements which fall within the purview of the Federal Arbitration Act ("FAA"), state law hostile to arbitration has been preempted. The decisions of this Court have consistently found that state law which obstructs the "liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary" must yield to federal law. *See Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983). Consistent with this policy, this Court has repeatedly found various state statutes and common law rules preempted by the FAA and has upheld only state procedural rules which are "manifestly designed to encourage resort to the arbitral process." *Volt*



*Information Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior University,* 489 U.S. 468, 476, 109 S.Ct. 1248, 103 L.Ed.2d 488 (1989).

The New York prohibition against arbitral awards of punitive damages cannot be reconciled with the federal substantive law of arbitrability and, in fact, represents the views of arbitration as an inferior and inappropriate means of dispute resolution which Congress expressly sought to overcome by enacting the FAA. The decision of the Seventh Circuit, however, serves to resurrect and enforce, as a matter of federal law, longstanding judicial prejudices against arbitration by construing contracts containing comprehensive arbitration clauses and state choice-of-law clauses to incorporate state law founded on those

prejudices. Accordingly, the Seventh Circuit's decision in this case must be reversed.

2. The Seventh Circuit's decision is even more deeply flawed because the court determined not just that the Mastrobuonos were not entitled to an arbitral forum for resolution of their punitive damages claim but that they were not entitled to *any* forum for resolution of those claims. The Seventh Circuit concluded that by agreeing to a choice-of-forum clause and a choice-of-law clause, the Mastrobuonos had waived any claim to punitive damages in any forum. In this way, the Seventh Circuit's decision disregards the concept of waiver as a voluntary relinquishment of a known right and construes the contract at issue in a manner which this Court has previously



indicated would render the contract unconscionable. *See Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 637, 105 S.Ct. 3346, 87 L.Ed.2d 444 (1985).

## ARGUMENT

### I.

### THE FAA PREEMPTS STATE LAW PROHIBITIONS AGAINST ARBITRAL AWARDS OF PUNITIVE DAMAGES.

In seeking to elucidate the scope and impact of the Federal Arbitration Act ("FAA), this Court has consistently held that, under the Supremacy Clause, the FAA preempts state law where it undermines the Congressional intent underlying enactment of the FAA. In enacting the FAA, Congress sought to place arbitration agreements "upon the same footing as other contracts" and to overcome, by legislative enactment, the judiciary's longstanding refusal to

enforce arbitration agreements arising out of "an anachronism in American law" derived from "the jealousy of the English courts for their own jurisdiction." See *Dean Witter Reynolds Inv. v. Byrd,* 470 U.S. 213, 219-220, 105 S.Ct. 1238, 84 L.Ed.2d 158 (1985), quoting from H.R. Rep. No. 96, 68th Cong., 1st Sess., 1-2 (1924).

For example, in its decision in *Prima Paint Corp. v. Flood Conklin Mfg. Co.*, 388 U.S. 395, 87 S.Ct. 1801, 18 L.Ed.2d 1270 (1967), the Court considered whether a claim of "fraud in the inducement" of a contract, which contained a broad arbitration clause, was to be decided in a judicial or arbitral forum, where there was "no evidence that the contracting parties intended to withhold that issue from arbitration." *Prima Paint,* 87 S.Ct at 1802. The Court concluded that an



arbitration clause is severable from the agreement which contains it and that, unless the allegation of "fraud in the inducement" goes specifically to the making of the arbitration agreement, rather than the contract as a whole, such claims are to be determined in arbitration. In reaching its decision, the Court resolved a conflict among the Circuits, upholding the view that, except where the parties otherwise intend, as a matter of federal law arbitration clauses are severable from the contracts in which they are contained. The Court rejected the view that the question of "severability" is one of state law and that where a state regards an arbitration clause as "inseparable" a claim of fraud in the inducement of the contract must be

decided by the courts. See *Prima Paint*, 388 U.S. at 403-404.

Subsequently, in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983), the Court more explicitly addressed the preemption issue, explaining:

> Section 2 [of the FAA] is the primary substantive provision of the Act, declaring that a written agreement to arbitrate "in any maritime transaction or a contract evidencing a transaction involving commerce...shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. §2. Section 2 is a congressional declaration of a liberal federal policy favoring arbitration agreements, *notwithstanding any state substantive or procedural policies to the contrary*. The effect of the section is to create a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the



> coverage of the Act. *Moses H. Cone*, 460 U.S. at 24. [Footnote omitted; emphasis added.]

The Court further stated:

> The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation or waiver, delay, or a like defense to arbitrability. *Moses H. Cone*, 460 U.S. at 24-25. [Footnote omitted.]

This Court has consistently relied upon these principles in determining that state law hostile to arbitration is preempted by the FAA. In *Southland Corp. v. Keating*, 465 U.S. 1, 104 S.Ct. 852, 79 L.Ed.2d 1 (1984), the Court addressed whether the FAA preempted a provision of the California Franchise Investment Law. The California Supreme Court had interpreted a provision of that statute to

require judicial consideration of claims brought under the statute and had concluded that the statute did not contravene the FAA. This Court reversed, finding that this construction of the California law directly conflicted with §2 of the FAA and therefore violated the Supremacy Clause. The Court ruled that the parties were required to arbitrate a dispute arising under a franchise agreement which contained a broad arbitration clause, notwithstanding the contrary state law provision. In reaching its decision, the Court reviewed the problems which Congress sought to obviate by passage of the FAA, reaffirmed its holdings in *Prima Paint* and *Moses H. Cone*, and made clear that the FAA creates a body of substantive federal law, enacted pursuant to Congress' authority under the



Commerce Clause, which is applicable both in state and federal courts. As the Court stated:

> In enacting §2 of the federal Act, Congress declared a national policy favoring arbitration and *withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties have agreed to arbitrate. Keating*, 465 U.S. at 10. [Emphasis added.]

Similarly, in *Perry v. Thomas*, 482 U.S. 483, 107 S.Ct. 2520, 96 L.Ed.2d 426 (1987), the Court considered whether the Federal Arbitration Act preempted a section of the California Labor Code which provided that actions for the collection of wages could be maintained "without regard to the existence of any private agreement to arbitrate." *Perry*, 482 U.S. at 484, quoting from Cal.Lab.Code Ann. §229 (West 1971). In *Perry*, the plaintiff brought suit in the California Superior

Court against his former employer, Kiddy Peabody & Co., and two of its employees to recover commissions allegedly due to him on the sale of securities, as well as compensatory and punitive damages. Defendants sought to compel arbitration under §§ 2 and 4 of the FAA, based on an agreement plaintiff had signed as part of his application for employment, by which he had agreed to submit to arbitration any dispute arising between himself and his firm, customers and or any other persons. Plaintiff resisted defendants' attempts to compel arbitration, asserting that the California Labor Code authorized his state court action, notwithstanding the agreement to arbitrate. The Court concluded that the California statute requiring that litigants be provided a judicial forum for resolving wage disputes



clearly conflicted with the federal policy of rigorous enforcement of arbitration agreements and that, under the Supremacy Clause, the California state statute "must give way." *Perry*, 482 U.S. at 491.

In a concurrent line of cases, including *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 105 S.Ct. 3346, 87 L.Ed.2d 444 (1985), and *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987), the Court further addressed the scope of the FAA, making clear that, as a matter of federal law, the parties may agree to arbitrate federal statutory claims even where those claims give rise to punitive-type remedies. In *Mitsubishi Motors*, the Court concluded that a claim based on the Sherman Act was arbitrable, where the parties' agreement

arose from an international transaction. In reaching its decision, the Court stated:

> [T]he first task of a court asked to compel arbitration of a dispute is to determine whether the parties agreed to arbitrate that dispute. The court is to make this determination by applying the "federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act." *Mitsubishi Motors*, 473 U.S. at 626. [Citations omitted.]

Reiterating that portion of its decision in *Moses H. Cone* wherein it held that doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, the Court stated, "Thus, as with any other contract, the parties' intentions control, but those intentions are generously construed as to issues of arbitrability." *Mitsubishi Motors*, 473 U.S. at 626. The Court found that the



agreement to arbitrate encompassed the statutory claims and that various considerations relating to an international transaction required enforcement of the parties' agreement, even if, in a domestic context, other policy considerations might preclude arbitration. The Court reached this decision, notwithstanding the important role of private enforcement contemplated under the Sherman Act, as evidenced by the availability of treble damages for violations of the Act. The Court noted that the Sherman Act's treble damages provision served both a remedial and a deterrent function, and that these functions were not circumvented by its decision. See *Mitsubishi Motors*, 473 U.S. at 636-637.

Specifically in the domestic context, in *McMahon* the Court considered whether, pursuant to a predispute arbitration agreement between a brokerage firm and its customers, claims brought pursuant to the Securities Exchange Act of 1934 and Racketeer Influenced and Corrupt Organizations Act must be arbitrated in accordance with the terms of the agreement. The Court commenced its analysis with a review of its prior decisions emphasizing the federal policy favoring arbitration. The Court concluded that both the Exchange Act and RICO claims were arbitrable, noting that the mistrust of the arbitral forum articulated in its prior decision in *Wilko v. Swan,* 346 U.S. 427, 74 S.Ct. 182, 98 L.Ed.2d 168 (1953), was difficult to reconcile with the Court's subsequent assessments of the



arbitral forum, and also that the concerns stated in *Wilko* had been obviated by the fact that, since the time of that decision, the Exchange Act had been amended to give the SEC expansive power to ensure the adequacy of the arbitration procedures employed by the national securities exchanges and registered securities associations.[2] With regard to the RICO claim, the Court stated that the primary purpose of the RICO treble damages provision is compensation but also recognized its important, but secondary, policing function. The Court concluded that the respondents could effectively vindicate both their Exchange Act and RICO claims in an arbitral forum and that there

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[2] Subsequently, in *Rodriguez de Quijas v. Shearson/American Express Inc.,* 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989), this Court expressly overruled its prior decision in *Wilko*.

was no inherent conflict between arbitration and the purposes underlying the RICO treble damages provision.

In reaching its decision in this case, the Seventh Circuit acknowledged the principles driving this Court's decisions in the above-discussed cases, but, in reliance on this Court's decision in *Volt Information Sciences, Inc. v. Bd. of Trustees of Leland Stanford Junior University*, 489 U.S. 468, 109 S.Ct. 1248, 103 L.Ed.2d 488 (1989), apparently found that the New York prohibition against arbitral awards of punitive damages embodied in *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976), was not inconsistent with the goals of the FAA and was not preempted by it. See *Mastrobuono v.*



*Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 716-717 (7th Cir. 1994), *cert. granted*, ___ U.S. ___, 115 S.Ct. 305, 130 L.Ed.2d 218 (1994). The Seventh Circuit's decision is, however, clearly at odds with the Congressional intent underlying the FAA and misconstrues and misapplies this Court's decision in *Volt*.

In *Garrity*, the New York Court of Appeals, in a closely divided decision, held that an arbitrator has no power to award punitive damages, even if agreed upon by the parties, and that enforcement of such an award would violate public policy. *Garrity*, 40 N.Y.2d at 357. The Court indicated that it was the exclusive province of the court or jury to award punitive damages (*Garrity*, 40 N.Y.2d at 358), and further stated, "The law does not and should not permit private persons

to submit themselves to punitive sanctions of the order reserved to the State." *Garrity*, 40 N.Y.2d at 360.

The decision in *Garrity*, however, represents precisely the type of careful vigilance which state courts extend to their jurisdiction which the FAA was expressly enacted to overcome with regard to "contracts evidencing a transaction involving commerce." The decision in *Garrity* is permeated with the misconceptions and prejudices against the arbitral forum which the FAA was enacted to defeat and which this Court has consistently refused to permit, even where such action meant overruling a prior decision which it found pervaded by "the old judicial hostility to arbitration." *Rodriguez*, 490 U.S. 477, 480 (1989), quoting from *Kulukundis Shipping Co. v.*



*Amtorg Trading Corp.*, 126 F.2d 978, 985 (2nd Cir. 1942). In *Garrity*, the New York Court of Appeals plainly sought to withdraw the parties' ability to agree to an arbitral award of punitive damages, reserving solely to the judicial forum the power to award punitive damages, notwithstanding any contrary agreement by the parties.

In *Prima Paint*, *Keating* and *Perry*, this Court has consistently rebuffed similar attempts to limit arbitrability, finding them antithetical to the FAA and concluding that such parochial views of arbitration may not prevail over countervailing federal policy.[3]

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[3] The decisions in *Prima Paint*, *Keating*, and *Perry* clearly apply with equal force to state law of a judicial, common law origin. As the Court stated in *Perry*, 482 U.S. at 492, n. 9:

In considering the precise issue presented here, relying on the principles articulated in this Court's decisions in *Prima Paint*, *Moses H. Cone*, *Keating*, and *Mitsubishi Motors*, the First, Eighth, Ninth and Eleventh Circuits have all held that the FAA preempts state law prohibiting arbitral awards of punitive damages incorporated into an arbitration agreement by means of a state choice-of-law clause.[4]

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> Nor may a court rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable, for this would enable the court to effect what we hold today the state legislature cannot.

[4] In *J. Alexander Securities, Inc. v. Mendez*, 17 Cal.App.4th 1083, 1090-1091, 21 Cal.Rptr.2d 826 (Cal. Ct. App. 1993), *cert. denied*, ____ U.S. ____, 114 S.Ct. 2182, 128 L.Ed.2d 901 (1994), the



In *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989), the First Circuit affirmed an arbitral award of punitive damages finding that the parties had agreed to submit all disputes arising out of their exclusive dealership contract to arbitration conducted according to the rules of the American Arbitration Association (hereinafter "AAA"). The First Circuit acknowledged that "the broad policies of the Federal Arbitration Act" governed its analysis and that the FAA expresses a strong federal

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California appellate court reached the same conclusion. In fact, in *Singer v. E.F. Hutton & Co., Inc.*, 699 F.Supp. 276 (S.D. Fla. 1988), the plaintiffs opposed the defendants' attempts to compel arbitration on the basis that they were entitled to punitive damages under some of their claims but that a New York choice-of-law provision prevented them from obtaining punitive damages in arbitration. The District Court compelled arbitration of all claims, finding that the FAA preempted the New York prohibition.

policy in favor of arbitration. *Raytheon*, 882 F.2d at 9. Using these considerations as the general context for its inquiry, the court further considered the fact that the arbitration clause contained in the parties' contract was "neither limited in its scope nor optional in its application" and the fact that it required arbitration to be conducted pursuant to the rules of the AAA, which "grant any remedy or relief which is just and equitable and within the terms of the agreement of the parties." *Raytheon*, 882 F.2d at 9-10. In light of the liberal construction which this Court has indicated should be accorded agreements to arbitrate (*Mitsubishi Motors*), the First Circuit concluded:

> [I]t would seem sensible to interpret the "all disputes" and "any remedy or relief" phrases to indicate, at a minimum, an intention to resolve through arbitration any dispute that



> would otherwise be settled in a court, and to allow the chosen dispute resolvers to award the same varieties of relief as a court would be empowered to award. *Raytheon*, 882 F.2d at 10.

Further, the court noted and approved the decisions of other jurisdictions which had held that a contract's choice-of-law provision does not require a reviewing court to determine whether arbitrators are empowered to award punitive damages by looking to the law of the chosen forum.

In its decision, the First Circuit made specific reference to this Court's decision in *Volt*. It found that the *Volt* decision did not alter its conclusions, distinguishing *Volt* on the basis that it involved the application of state *procedural* rules relating to arbitration, not the construction of the scope of an arbitration agreement.

Similarly, in *Lee v. Chica*, 983 F.2d 883 (8th Cir. 1993), *cert. denied*, ___ U.S. ___, 114 S.Ct. 287, 126 L.Ed.2d 237 (1993), the Eighth Circuit affirmed an arbitral award of punitive damages in a dispute arising out of a brokerage customer agreement. On appeal, the Eighth Circuit framed the issue before it as "whether federal or state law applies in interpreting the arbitration clause in the agreement and in determining if arbitrators can award punitive damages." *Lee*, 983 F.2d at 885. The Eighth Circuit rejected the reasoning applied by the Seventh Circuit in this case, ruling that federal law, not state law, governed the issue. The court further noted that the parties had agreed that any arbitration would be conducted in accordance with the Rules of the AAA, that the Rules of the



AAA permitted awards of punitive damages, and that the FAA gives force to the Rules of the AAA. *See Lee*, 983 F.2d at 887-888.[5]

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[5] The Eighth Circuit had previously reached a similar conclusion in *Collins Radio Company v. Ex-Cell-O Corp.*, 467 F.2d 995 (8th Cir. 1972), wherein the plaintiff opposed defendant's attempts to stay the action brought in the District Court, asserting that the parties' contract contained a Texas choice-of-law provision and that the arbitration agreement was invalid under Texas law because it failed to conform with Texas statutory requirements. In affirming the District Court's order staying the District Court proceedings, the Eighth Circuit stated:

> [Section 2 of the FAA] plainly voids all doctrines of invalidity, unenforceability and revocability which apply only to arbitration agreements. The plain meaning of §2 is that federal courts are no longer to apply state statutes and decisions which limit arbitration agreements with rules not applicable to other agreements. *Collins*, 467 F.2d at 998.

In *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991), the Ninth Circuit affirmed an arbitral award of $1 million, rejecting the defendant's assertion that a New York choice-of-law provision contained in the parties' contract precluded an arbitration award of punitive damages. In this respect, the Ninth Circuit held that federal law, rather than New York state law, controlled and that federal law permitted arbitral awards of punitive damages. *Todd,* 943 F.2d at 1062-1063.

In reaching its decision, the Eleventh Circuit also made specific reference to this Court's decision in *Volt*. It found that the Court "merely said that it would not disturb a state court's factual determination that the parties to the contract in *Volt* intended



to invoke California arbitration rules." *Todd,* 943 F.2d at 1062, citing *Volt*, 109 S.Ct. at 1255.

In *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988), the defendant argued that a panel of arbitrators lacked power under a brokerage customer agreement, containing a New York choice-of-law provision, to award punitive damages. The customer agreement at issue also contained a broadly worded arbitration clause and provided that arbitration was to be held in accordance with the rules of the Arbitration Committee of the Chamber of Commerce of the State of New York, the American Arbitration Association or the Board of Arbitration of the New York Stock Exchange, as selected by the plaintiffs. Relying on its earlier decision in

*Willoughby Roofing & Supply Co. v. Kajima International, Inc.*, 598 F.Supp. 353, *affirmed*, 776 F.2d 269 (11th Cir. 1985), as well as this Court's decision in *Moses H. Cone*, the Eleventh Circuit concluded that any doubts concerning the scope of arbitrable issues were to be resolved in favor of arbitration and that the arbitrators could, upon remand, award punitive damages if they found that the facts warranted such an award.[6] The court reaffirmed the conclusions reached in *Willoughby*, stating:

> [A] choice of law provision in a contract governed by the Arbitration Act merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages; it

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[6] Based on false testimony given in the arbitration by plaintiffs' expert, the court determined that remandment was necessary.



> does not deprive the arbitrators of their authority to award punitive damages. *Bonar*, 835 F.2d at 1387, citing *Willoughby*, 598 F.Supp. at 359.

In reaching its decision in this case, the Seventh Circuit rejected the decisions of the First, Eighth, Ninth and Eleventh Circuits, relying instead on its own prior precedent in *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984), and a construction of *Volt* which cannot be rationally related to other prior decisions of this Court.[7]

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[7] The Seventh Circuit's decision in this case accords with the decisions of the Second Circuit in *Fahnestock & Co. v. Waltman*, 935 F.2d 512 (2nd Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S.Ct. 389, 116 L.Ed.2d 331 (1991), and *cert. denied*, ___ U.S. ___, 112 S.Ct. 1241, 117 L.Ed.2d 474 (1992), and *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117 (2nd Cir. 1991).

It should, however, be noted that the Seventh Circuit's decision in this case appears to conflict with its own prior decision in *Commonwealth Edison Co. v. Gulf Oil Corp.*, 541 F.2d 1263 (7th Cir. 1976), wherein the defendants argued that

In *Volt*, this Court addressed whether the FAA preempted a provision of the

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because the parties' contract contained an Illinois choice-of-law clause, the Illinois Uniform Arbitration Act governed the contract and, under that Act, the question of the existence of an agreement to arbitrate was to be decided by the courts. The Seventh Circuit found that the FAA, rather than the Illinois Arbitration Act controlled, concluding:

> Parties are not free to burden the arbitration process under the Federal Act by adopting state law that shifts the determination of disputes from arbitrators to the courts. To allow parties to so contract would undermine the provisions of the Federal Act. Congress, in enacting the Federal Arbitration Act, exercised its power over admiralty and interstate commerce. Any arbitration contract involving one of those areas is governed by the Federal Act. To permit the parties to contract away the application of the Act by adopting state law to govern their agreement would be inconsistent with the Act itself and with the holding in *Prima Paint*. *Commonwealth Edison,* 541 F.2d at 1269.



California Arbitration Act which allowed a court to stay arbitration pending the resolution of related litigation. In *Volt*, the agreement between the parties contained a broad arbitration clause as well as a choice-of-law provision stating that the law of the place where the project was located, California, would govern. A dispute arose and Volt made a formal demand for arbitration. In response, Stanford filed an action against Volt in the California Superior Court, seeking recovery against Volt and two other companies with which it did not have arbitration agreements. Volt petitioned the Superior Court to compel arbitration of the dispute and to stay the state court litigation until the arbitration was complete. Stanford, on the other hand, moved to stay the arbitration, pursuant to

a provision of the California Arbitration Act which allowed a court to stay arbitration pending resolution of related litigation between a party to the arbitration agreement and third parties not bound by it "where there is a possibility of conflicting rulings on a common issue of law or fact." The California trial court granted Stanford's motion to stay the arbitration and denied Volt's motion. The California appellate court affirmed, noting that the FAA applied, that the FAA contained no provision permitting a stay of arbitration pending the outcome of related litigation involving third parties not bound by the arbitration agreement, but that by virtue of the choice-of-law clause, the parties had incorporated the California arbitration rules into their contract.



The California Supreme Court denied discretionary review.

In reaching its decision, this Court initially rejected Volt's contention that the California appellate court's decision was, in effect, a finding that Volt had waived its "federally guaranteed right to compel arbitration." *Volt*, 489 U.S. at 475. The Court also rejected Volt's contentions that the California appellate court's construction of the choice-of-law clause contained in the parties' agreement conflicted with the federal policy favoring arbitration and that the FAA preempted the California stay provision. *Id.*, at 476. With regard to the preemption issue, the Court explained that, "even where Congress has not completely displaced state regulation in an area, state law may nonetheless be

preempted to the extent that it actually conflicts with federal law - that is, to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" *Id.*, at 477, quoting from *Hines v. Davidowitz,* 312 U.S. 52, 67, 61 S.Ct. 399, 85 L.Ed. 581 (1941). The Court framed the preemption issue as whether application of the California procedural stay provision, in accordance with the terms of the arbitration agreement, would undermine the goals and policies of the FAA and concluded that it would not.

Contrary to the Seventh Circuit's interpretation, the decision in *Volt* does not abrogate preemption concerns relating to enforcement of arbitration clauses which also contain choice-of-law clauses. In *Volt*, the Court found that a state



court construction of an arbitration agreement to encompass state procedural rules did not offend §4 of the FAA because that provision provides "only a right to obtain an order directing that "arbitration proceed *in the manner provided for in [the parties'] agreement.*" *Volt,* 489 U.S. at 474-475, quoting from 9 U.S.C. § 4. [Emphasis in the original.] The Court further concluded that enforcement of state *procedural* rules which are not designed to inhibit arbitration do not offend the FAA, stating:

> There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate. Interpreting a choice-of-law clause to make applicable state rules governing the conduct of arbitration - *rules which are manifestly designed to encourage*

> *resort to the arbitral process* - simply does not offend the rule of liberal construction set forth in *Moses H. Cone*, nor does it offend any other policy embodied in the FAA. *Volt*, 489 U.S. at 476. [Footnote omitted; emphasis added.]

This Court's decision in *Volt* cannot be read, as the Seventh Circuit suggests, to hold that *substantive* state law restraints on the scope of an arbitrator's power which fundamentally subvert the federal substantive law of arbitrability, incorporated into an agreement by means of a choice-of-law clause, are not preempted by the FAA. In *Volt*, the Court made explicit what a number of its prior decisions alluded to, that is that the FAA has not completely preempted the entire field of arbitration and the states may supply procedural arbitration rules which "are manifestly designed to encourage resort to the arbitral process," provided



those rules do not "offend" the "substantive" provisions of the FAA.[8] The

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[8] In *Securities Industry Association v. Connolly*, 883 F.2d 1114 (1st Cir. 1989), a trade association of securities broker-dealers successfully challenged Massachusetts state regulations which required, among other things, that broker-dealers not make execution of a pre-dispute arbitration agreement a non-negotiable precondition to opening a customer account, conspicuous disclosure that such a condition could not be made non-negotiable and a full written disclosure of the legal effect of a pre-dispute arbitration agreement. The First Circuit found in favor of the broker dealers and held that these regulations were preempted by the FAA, concluding that this Court's decision in *Volt* did not require a contrary result. In this regard, the First Circuit stated:

> But, the choice-of-law provision in *Volt* did not impinge the enforceability of the arbitral contract. The California regulation filled in an interstice in the FAA, whereas the regulations here at issue plainly undermine the presumption of validity that the Act meant to confer on arbitration contracts generally. *Securities Industry Association*, 883 F.2d at 1119. [Citations omitted.]

Court specifically noted that although the "substantive" provisions of the FAA, §§1 and 2, have been held to apply in state and federal courts, it had never held that §§3 and 4 of the FAA, "which by their terms appear to apply only to proceedings in federal court," are "nonetheless applicable in state court." *Volt*, 489 U.S. at 468, n. 6. In light of this acknowledgement, it is not at all surprising that the Court concluded that application by a state court of state law procedures, which were "manifestly designed to encourage resort to the arbitral process," are not preempted by the FAA. In fact, the Court noted:

> [W]e think the California arbitration rules which the parties have incorporated into their contract generally foster the federal policy favoring



> arbitration. As indicated, the FAA itself contains no provision designed to deal with the special practical problems that arise in multiparty contractual disputes when some or all of the contracts at issue included agreements to arbitrate. California has taken the lead in fashioning a legislative response to this problem, by giving courts authority to consolidate or stay arbitration proceedings in these situations in order to minimize the potential for contradictory judgments." *Volt*, 489 U.S. at 476, n. 5.[9]

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[9] The Court's views in this regard were anticipated in its prior decision in *Moses H. Cone*. In *Moses H. Cone*, the Court noted that under the FAA an arbitration agreement must be enforced notwithstanding the presence of other persons who are parties to the underlying dispute but not the arbitration agreement. In this regard, the Court noted, "In some cases, of course, it may be advisable to stay litigation among the nonarbitrating parties pending the outcome of arbitration. That decision is one left to the district court (or to the state trial court under applicable state procedural rules) as a matter of its discretion to control its docket." *Moses H. Cone*, 460 U.S. at 20, n. 23. [Citation omitted.]

Similarly, in her dissenting opinion in *Keating*, Justice O'Connor (who was

The Seventh Circuit's decision, as well as the similar decisions from the Second Circuit, make no reference to the impact of their decisions on other factual scenarios whether impacting on punitive damages or any other issue determined to be unenforceable by arbitrators. Assume Mr. DiMinico's employment agreement with Shearson had a similar comprehensive arbitration agreement. Does that mean the punitive damages remedies in an age discrimination or disability action against Shearson are withdrawn from an arbitrator's consideration? Assume there

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joined in her dissent by Justice Rehnquist, the author of the majority's opinion in *Volt*), stated that the states should be afforded the opportunity to develop their own methods for enforcing "the new federal rights" which she viewed the majority's decision applying §2 of the FAA in state courts to create. *Keating*, 465 U.S. at 31-32 (O'Connor, J., dissenting).



are other states with "policy considerations" on compensatory awards for sexual harassment claims of employees. Do employees forgo those claims because of choice-of-law provisions inserted in the arbitration agreement by sophisticated employers?

On that subject, one can just imagine the search for states with favorable substantive precedent to fuel these agreements to the disadvantage of the consumers or investors who consider themselves safeguarded by the Federal Arbitration Act. The *Mastrobuono* decision does more than neutralize the value of the FAA; it serves to disadvantage the unsophisticated investor in favor of the sophisticated members of the securities industry.

Here, the "*Garrity* rule" which the Seventh Circuit found controlling, unlike the California procedural rules which the Court in *Volt* found promoted arbitration, is simply an antiquated remnant of "judicial hostility toward arbitration" which the FAA was expressly enacted to overcome. Moreover, unlike the procedural rules which the Court found were not preempted by the FAA in *Volt*, the incorporation of the New York rule prohibiting arbitral awards of punitive damages is clearly a substantive or outcome-determinative limitation on arbitrability.[10] This is clear from the

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[10] Here, the parties expressly provided that the arbitration was to be held "in accordance with the rules of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchanged Inc. as [petitioners] may elect." (Pet. App. 44). The Seventh Circuit acknowledged



*Garrity* decision itself, wherein the New York Court of Appeals expressed the issue as a question of the scope of an arbitrator's power and the ability of contracting parties to define the scope of an arbitrator's authority, versus the realm of exclusive judicial authority. With regard to contracts evidencing transactions involving commerce, such an issue is clearly governed by the FAA. As this Court in *Volt*, reaffirmed:

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that the NASD Code Of Arbitration Procedure is "prescribed and adopted...for the arbitration of any dispute, claim or controversy," that the NASD Arbitrator's Manual provides that "[p]arties to an arbitration are informed that arbitrators can consider punitive damages as a remedy," and that NASD Rule of Fair Practice 21(f)(4) provides that "[n]o agreement shall included any condition which...limits the ability of the arbitrators to make any award," but concluded that the New York law prohibiting arbitral awards of punitive damages was controlling. (*Mastrobuono*, 20 F.3d at 717-718; Pet. App. 15-18).

> In recognition of Congress' principal purpose of ensuring that private arbitration agreements are enforced according to their terms, we have held that the FAA pre-empts state laws which "require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Volt*, 489 U.S. at 478-479. [Citations omitted.]

## II.

## PETITIONERS DID NOT WAIVE THEIR RIGHT TO RECOVER PUNITIVE DAMAGES FOR THE EGREGIOUS MISCONDUCT OF RESPONDENTS BY AGREEING TO A COMPREHENSIVE ARBITRATION CLAUSE AND A NEW YORK CHOICE-OF-LAW CLAUSE.

The Seventh Circuit went beyond the "*Garrity* rule" in its decision because *Garrity* did not expressly foreclose recovery of punitive damages in a judicial forum. The Seventh Circuit concluded not only that the Mastrobuonos' punitive damages claims were not arbitrable but also that they had waived *any* right to



recover punitive damages in *any* forum because, "[u]nder the plain language of the agreement, the [petitioners] are entitled only to the damages available in arbitration under New York law." *Mastrobuono*, 20 F.3d at 718. This principle manifestly disregards the longstanding federal goal of investor protection, which is evidenced in both the Securities Act of 1933 and the Securities Exchange Act of 1934, and presents the preposterous result of permitting broker-dealers to utilize the Federal Arbitration Act to exculpate themselves from the consequences of their egregious misconduct through the facially innocuous device of a New York choice-of-law clause in a contract which also contains a broad arbitration clause. The Seventh Circuit's conclusion in this regard is clearly

untenable; it fundamentally subverts the concept of waiver and renders the contract at issue unconscionable.

A waiver is a voluntary and intentional relinquishment of a known right. (*See, e.g., Johnson v. Zerbst,* 304 U.S. 458, 464, 58 S.Ct. 1019, 82 L.Ed. 1461 (1938); *Bonar v. Dean Witter Reynolds, Inc.,* 835 F.2d 1378, 1387-1388 (11th Cir. 1988)). In *Bonar*, the Eleventh Circuit correctly refused to find a waiver under circumstances essentially identical to those presented here, finding:

> As our previous discussion demonstrates, the customer agreement was far from a model of clarity on the subject of punitive damages. Paragraph 16, incorporating by reference the rules of the American Arbitration Association, allowed the arbitrators to "grant any remedy or relief which [they] deem[ed] just and equitable and within the scope of the agreement of the parties." Paragraph 17 provided that New



> York law would govern the agreement and its enforcement. *The agreement never explicitly mentioned punitive damages. Simply by signing such an ambiguous agreement, the appellees could not have intended to relinquish their right to punitive damages. Dean Witter's argument ignores the definition of waiver.* Bonar, 835 F.2d at 1388. [Citations omitted; footnote omitted; emphasis added].

The Seventh Circuit's decision ignores the definition of waiver, but is also predicated on an illogical analysis. As this Court has recognized, an arbitration clause is a special type of forum selection clause. See *Mitsubishi Motors,* 473 U.S. at 630. As such, it is designed to determine the forum in which disputes will be resolved but not to limit the substantive claims which the parties may assert in that forum. As this Court explained in *Mitsubishi Motors*:

> By agreeing to arbitrate a statutory claim, a party does not forgo the *substantive* rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum." *Mitsubishi Motors,* 473 U.S. at 628. [Emphasis added.]

See also, *Rodriguez,* 490 U.S. at 481. Accordingly, it cannot fairly be concluded, as the Seventh Circuit did, that in the absence of some explicit provision to the contrary, parties who have simply agreed to submit their claims to arbitration, including those giving rise to punitive damages, intended only a full adjudication of the substance of those claims but not a full adjudication of the remedies to which they may be entitled. As the First Circuit explained in *Raytheon*:

> [W]e agree that punitive damages can serve as an effective deterrent to malicious or fraudulent conduct. Where such



> conduct could give rise to punitive damages if proved to a court, there is no compelling reason to prohibit a party which proves the same conduct to a panel of arbitrators from recovering the same damages. Certainly, the fact that the parties agreed to resolve their dispute through an expedited and less formal procedure does not mean that they should be required to surrender a legitimate claim to damages. Parties that do wish arbitration provisions to exclude punitive damages claims are free to draft agreements that do so explicitly. In this case, no such exclusion from the general language of the arbitration clause exists. *Raytheon,* 882 F.2d at 12.

Moreover, construing the inclusion of a New York choice-of-law clause and a comprehensive agreement to arbitrate to result in a waiver of the petitioners' ability to recover punitive damages for the egregious misconduct of respondents renders the agreement unconscionable. As stated by Justice Blackmun in

*Shearson/American Exp., Inc. v. McMahon*, 482 U.S. 220, 261, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987) (Blackmun, J., concurring in part and dissenting in part):

> The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be *some* truth to the investors' belief that the securities industry has an advantage in a forum under its own control. See N.Y. Times, Mar. 29, 1987, section 3, p. 8, col. 1 (statement of Sheldon H. Elsen, Chairman, American Bar Association Task Force on Securities Arbitration: "The houses basically like the present system because they own the stacked deck"). [Footnote omitted, emphasis in original].

The Seventh Circuit has endorsed the ability of a party with a superior bargaining position to "stack the deck" and, under the guise of an *explicit* predispute waiver of a judicial forum, to



which the parties certainly may agree, effectuate an *implicit* waiver of an existing right to recover punitive damages within that judicial forum. The only party benefitted by this "waiver" is the securities dealer and his firm, here, the respondents. Ironically, here, as is generally the case, the parties who imposed the arbitration clause and have compelled arbitration now seek to obviate the result of that arbitration, apparently realizing that the deck was not "stacked" as anticipated.

Unlike the situation presented in *Volt*, where the issue presented was the management of interrelated arbitral and judicial proceedings and a state's ability to regulate such proceedings in the absence of an applicable federal directive

on that issue,[11] the decision of the Seventh Circuit has construed the juxtaposition of an arbitration clause and New York choice-of-law clause to deprive the Mastrobuonos, and presumably any other investor, of *any* forum, arbitral or judicial, for determination of their punitive damages claims. The position articulated by respondents and adopted by the Seventh Circuit is simply that by agreeing to a choice-of-forum and with a choice-of-law clause, these investors have foreclosed themselves from any ability to recover punitive damages in any forum.

The usefulness of this "waiver by implication" precedent does not end with just punitive damages. One can hypothecate any number of similar issues

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[11] See *Volt*, 489 U.S. at 477, n. 6.



which choice-of-law provisions may obviate, depending on the state of choice, thereby increasing the prejudice to investors and the degree to which the deck can be stacked against them. And the vehicle utilized is, paradoxically, the Federal Arbitration Act.

This Court has previously stated that it would not countenance such a scenario. In *Mitsubishi Motors*, the Court declined to consider the potential effect of any refusal by the arbitral panel to recognize an American statutory cause of action under the Sherman Act, in light of a Swiss choice-of-law clause, on the claimant's ability to reinstitute suit in the federal court. The Court did, however, expressly note that "in the event the choice-of-forum and choice-of-law clauses operated in tandem as a prospective waiver of a

party's right to pursue statutory remedies for antitrust violations, we would have little hesitation in condemning the agreement as against public policy." *Mitsubishi Motors,* 473 U.S. at 637, note 19. [Citations omitted.]

An analogous situation is presented here. Respondents assert that the choice-of-forum clause, the comprehensive arbitration clause contained in the parties agreement, together with the New York choice-of-law clause, operated as a prospective waiver of the Mastrobuonos' right to pursue punitive damages as a remedy for both their common law and statutory claims. Accordingly, even accepting the Seventh Circuit's construction of the parties' agreement as resulting in an implicit predispute waiver of the Mastrobuonos' right to recover



punitive damages, the agreement would be void as contrary to public policy.

**CONCLUSION**

For the foregoing reasons, petitioners respectfully request that this Court reverse the judgment of the Seventh Circuit Court of Appeals and remand this cause for confirmation of that portion of the arbitrators' award awarding petitioners punitive damages in the amount of $400,000 or, in the alternative, for a trial before the District Court on the amount of punitive damages or, in the further alternative, for a trial on petitioners' statutory and common law

claims giving rise to their claims for punitive damages.

Respectfully submitted,

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# APPENDIX

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9 U.S.C. §2 provides:

**Validity, irrevocability, and enforcement of agreements to arbitrate.**

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. §3 provides:

**Stay of proceedings where issue therein referable to arbitration.**

If any suit or proceeding be brought in any of the Courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.



9 U.S.C. §4 provides, in relevant part:

**Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination.**

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement....The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement....

U.S.C. §10(a) provides:

**Award of Arbitrators; vacation; grounds; rehearing.**

(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration -

(1) Where the award was procured by corruption, fraud, or undue means.

(2) Where there was evident partiality or corruption in the arbitrators, or either of them.

(3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.

(4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

(5) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

Supreme Court, U.S.
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NOV 16 1994
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No. 94-18

# In the Supreme Court of the United States

OCTOBER TERM, 1994

ANTONIO C. MASTROBUONO, ET AL., PETITIONERS

*v.*

SHEARSON LEHMAN HUTTON, INC., ET AL.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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## QUESTION PRESENTED

Whether the district court erred in vacating the arbitral award of punitive damages in this case.

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# In the Supreme Court of the United States

OCTOBER TERM, 1994

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No. 94-18

ANTONIO C. MASTROBUONO, ET AL., PETITIONERS

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SHEARSON LEHMAN HUTTON, INC., ET AL.

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*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

---

### INTEREST OF THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION

This case involves a dispute between a securities broker-dealer and two of its customers, which was arbitrated pursuant to a pre-dispute arbitration agreement under the rules of the National Association of Securities Dealers, Inc. (NASD).[1] The issue

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[1] The NASD is registered with the Securities and Exchange Commission as a national securities association under Section 15 A of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3. It is the only such registered national securities association. Subject to comprehensive oversight by the Commission, the NASD has primary responsibility under the Act for regulation of those who sell securities in the over-the-counter mar-

is whether a choice-of-law provision in the arbitration agreement precluded the customers from obtaining punitive damages—a remedy that would have been available to them if their claims had been resolved in court rather than arbitration.

As part of its regulatory mandate under the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*, the Securities and Exchange Commission has the responsibility for overseeing and approving the rules of the NASD and other self-regulatory organizations (SROs), such as the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEl), to assure that they adequately protect the rights of customers. See *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 233-234 (1987). This oversight extends to the administration of arbitration systems by the NASD, NYSE, AMEX and other SROs.[2] The arbitration systems operated by the NASD and other SROs pursuant to rules approved by the Commission play an important role in investor protection by affording brokerage

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ket. By virtue of Section 15(b)(8) of the Exchange Act, 15 U.S.C. 78o(b)(8), all broker-dealers that deal with retail customers in non-exempt securities must belong to the NASD.

[2] In addition to the NASD, NYSE, and AMEX, the Municipal Securities Rulemaking Board, Pacific Stock Exchange, Chicago Stock Exchange (formerly the Midwest Stock Exchange), Boston Stock Exchange, Chicago Board Options Exchange, Cincinnati Stock Exchange and Philadelphia Stock Exchange also administer arbitration programs. See Order Approving Proposed Rule Changes by the NYSE, NASD and AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Comm. Rel. No. 34-26805, 54 Fed. Reg. 21,144, 21,145 n.7 (1989) (hereinafter 1989 Release).



firm customers a simple, quick, and inexpensive means of redress. A large percentage of customer accounts with securities broker-dealers are subject to account agreements that require arbitration of disputes between the parties.[3] The Commission has a substantial interest in ensuring that arbitration agreements between brokerage firms and their customers comply with applicable SRO rules, including rules that require that arbitration not be used as a means to deprive customers of remedies that would be available in a judicial forum. The Commission is also concerned that arbitration not be made more complex, time-consuming, and expensive by failure to adhere to the fundamental principle that construction of an arbitration contract is for the arbitrators, not the courts, and that arbitration agreements be interpreted in a manner consistent with the Federal Arbitration Act.

The United States has a similar interest, in other litigation contexts, in the correct interpretation and application of the Federal Arbitration Act and in the effectiveness of the arbitral remedies authorized by that Act.

## STATEMENT

In 1985 petitioners, Illinois residents, became customers of respondent Shearson Lehman Hutton, Inc., a securities broker-dealer firm and member of the

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[3] See 1989 Release, 54 Fed. Reg. at 21,153 n. 51, which reported the results of a 1988 Commission study of 65 broker-dealer firms representing 90% of all customer trading accounts in the United States. According to that study, 96% of the margin accounts, 95% of the options accounts, and 39% of the cash accounts were subject to pre-dispute arbitration agreements.

NASD. The customer agreement executed by petitioners and the firm provided, in relevant part, that

> [the agreement] shall be governed by the laws of the State of New York. * * * [A]ny controversy arising out of or relating to [the petitioners'] accounts * * * shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as [the petitioners] may elect.

Pet. App. 44.

In January 1989 petitioners filed suit in the United States District Court for the Northern District of Illinois against Shearson and respondent Nick DiMinico, the Shearson employee who handled their account. Petitioners' complaint alleged unauthorized trading, churning, and margin exposure in their account. Petitioners sought compensatory damaages under federal securities law, as well as compensatory and punitive damages under state law.[4] In April 1989 respondents filed a motion to compel arbitration, which the district court granted. Pet. App. 3-4.

Petitioners commenced arbitration before the NASD. Their complaint alleged violations of the NASD Rules of Fair Practice, the Securities Exchange Act, SEC Rule 10b-5, the Illinois Consumer Fraud Act, and the Texas Deceptive Trade Practices-Consumer Protection Act. Petitioners also alleged breach of fiduciary duty and negligence. Hearings

[4] Punitive damages are not available under the Exchange Act. See 15 U.S.C. 78bb(a).



were conducted before a panel of three arbitrators in August and September 1992. Respondents contended, *inter alia*, that the arbitrators had no authority to award punitive damages. In October 1992 the arbitrators awarded the petitioners approximately $160,000 in compensatory damages and $400,000 in punitive damages. Pet. App. 4-5.

Respondents then moved in federal district court for vacatur of the punitive damages award. Petitioners moved to confirm the award; in the alternative, they contended that their claim for punitive damages should be tried before the district court. Pet. App. 5-6. The district court granted respondents' motion to vacate. Under New York law, the court noted, the power to award punitive damages is reserved to the courts and may not be exercised by arbitrators. *Id.* at 33 (citing *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976)). The court concluded that "[b]ecause the [petitioners] agreed to arbitrate their dispute in accordance with laws of the State of New York, and because the Agreement does not explicitly or by incorporation authorize the award of punitive damages, the remedies available to them are limited by the *Garrity* rule." Pet. App. 38-39.

The court of appeals affirmed. Pet. App. 1-27. The court of appeals first rejected petitioners' contention that the district court had reviewed the arbitral award under an insufficiently deferential standard.[5] The court acknowledged that "[t]he arbitrator's errors of law and contract construction are normally

[5] Section 10(a)(4) of the Federal Arbitration Act, 9 U.S.C. 10(a)(4) (1988 & Supp. V 1993), provides that an arbitral award may be vacated if, *inter alia*, "the arbitrators exceeded their powers."

unreviewable," but asserted that the "narrow scope of review does not immunize an award clearly unauthorized by the terms of the agreement." Pet. App. 8. The court concluded that "where the arbitrators are not entitled to award punitive damages due to a choice of law provision in the parties' agreement, it is 'manifest' that the arbitrators would exceed their powers by awarding punitive damages." *Id.* at 8-9 (citing *Barbier* v. *Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991)).

The court of appeals next held that the inclusion in the arbitration agreement of a choice-of-law clause referencing New York law precluded an arbitral award of punitive damages. The court stated that "[b]ecause any condition imposed by New York law can be found in the books, a choice of law provision suffices to incorporate the *Garrity* rule." Pet. App. 14. The court rejected petitioners' argument that Rule 21(f)(4) of the NASD Rules of Fair Practice required a different outcome. That Rule provides:

> No agreement [between a member and a customer] shall include any condition which * * * limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.[6]

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[6] NASD Rule 21(f) was developed under the auspices of the Securities Industry Conference on Arbitration (SICA), which was formed in 1977 to work with the Commission to monitor and improve the system of SRO arbitration. See 1989 Release, 54 Fed. Reg. at 21,144-21,145. The relevant provisions of the rules of the NYSE and the AMEX are substantially identical to the NASD Rule discussed here. Compare NASD Art. III, Rule 21(f) of the NASD's Rules of Fair Practice with NYSE Rule 636 and AMEX Rule 427.



The court held that "[t]o the extent that this provision conflicts with New York law, the governing law of the agreement under all the circumstances, we must conclude that the parties intended to be bound by New York law." Pet. App. 17.

## SUMMARY OF ARGUMENT

1. NASD Rule 21(f)(4) forbids the inclusion in broker-client arbitration agreements of provisions limiting the ability of arbitrators to award relief that would be available in a judicial forum. That Rule has an effective date of September 7, 1989; with respect to agreements executed after that date, the Rule has the force of federal law and precludes the enforcement of contractual provisions that are inconsistent with its terms. With respect to agreements (such as the contract at issue here) signed on or before September 7, 1989, Rule 21(f)(4) does not apply. This case consequently presents a question of contract interpretation, not of preemption by federal securities law. Regardless of the resolution of this case, however, it is important that the Court leave no confusion as to the operation of Rule 21(f)(4) with respect to agreements signed after the Rule's effective date.

2. The arbitrators in this case did not "exceed[] their powers" within the meaning of 9 U.S.C. 10(a)(4). The arbitral award of punitive damages should therefore have been confirmed.

a. Under the Federal Arbitration Act, a losing party is not entitled to appeal the arbitrator's decision on grounds of legal error. Although the Act permits a court to vacate an arbitral award under certain narrow circumstances, judicial review under

the statute must reflect substantial deference to the arbitrator's construction of an ambiguous agreement. As this Court has recognized in decisions under the federal labor statutes, the arbitrator's discretion is particularly broad—and judicial interference with the exercise of that discretion particularly inappropriate—in the formulation of appropriate remedies. While the court of appeals purported to respect the stringent limitations on its reviewing authority, its decision to affirm the vacatur of the arbitral award was based in essence on its belief that the arbitrator had misconstrued the contract. That belief provides a fundamentally inadequate basis for vacatur: The essence of arbitration is the parties' agreement that the arbitrator rather than the courts will be entrusted with the task of interpreting their contract.

b. The arbitral award of punitive damages in this case was based on an entirely reasonable reading of the parties' agreement. As this Court has repeatedly emphasized, an agreement to arbitrate ordinarily has the consequence only of changing the forum in which a dispute is to be resolved; it does not entail a waiver of substantive rights. This Court has also stressed that the FAA was intended to counteract prior hostility to arbitration as a means of dispute resolution. The *Garrity* rule, by contrast, rests largely on the mistrust of arbitrators that the FAA has rejected, and its application would transform the agreement to arbitrate into a surrender of substantive rights. The parties are unquestionably permitted (insofar as the FAA is concerned) to agree to such constraints on the arbitrator's remedial power. Because the *Garrity* rule runs counter to the premises underlying the FAA, however, such an agreement should



not be inferred by the courts (as a basis for vacating an arbitration award) absent an unambiguous indication that this was the parties' intent.

The agreement at issue in this case provides no clear indication that the parties intended to preclude an award of punitive damages. Although the agreement referenced the law of New York, it was plainly within the contemplation of the parties that other bodies of law (most obviously the federal securities laws) might be consulted in the process of resolving any disputes that might arise. The agreement expressly provided that any arbitral proceedings would be conducted in accordance with the rules of the NASD; and those rules do not restrict the types of relief an arbitrator may award. In our view, these provisions are most reasonably harmonized by applying New York law to determine what substantive rights and obligations are created by the contract, while applying NASD rules to resolve questions concerning the conduct of the arbitral proceedings and the scope of the arbitrators' authority. We note as well that the *Garrity* rule would clearly be preempted if the agreement contained no choice-of-law clause and New York law applied on the basis of the State's connection to the parties, the contract, and the contested transactions. The choice-of-law clause in this agreement should not be read to incorporate state law principles that would be preempted if New York law applied of its own force as a result of the State's connection to the relevant primary conduct.

## ARGUMENT

### I. WITH RESPECT TO AGREEMENTS BETWEEN BROKERS AND CUSTOMERS EXECUTED AFTER SEPTEMBER 7, 1989, FEDERAL LAW PROHIBITS THE ENFORCEMENT OF ANY CONTRACTUAL PROVISION THAT WOULD DEPRIVE CUSTOMERS OF REMEDIES THAT WOULD BE AVAILABLE IN A JUDICIAL FORUM

Rule 21(f)(4) of the NASD Rules of Fair Practice prohibits member firms from including in their customer agreements any contractual provision that "limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." As explained by the Commission when it approved the Rule,

> [t]his provision makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes represents solely a choice of arbitration as a means of dispute resolution. Agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum. If punitive damages * * * would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them.

1989 Release, 54 Fed. Reg. at 21,154. NASD Rule 21(f)(5) provides that "[t]he requirements of subparagraphs (f)(1) through (4) shall apply only to new agreements signed by an existing or new customer of a member after September 7, 1989."

With respect to contracts executed after September 7, 1989, Rule 21(f)(4)—like the rules of SROs generally—carries the force of federal law. See, *e.g.*, 15 U.S.C. 78f(b)(6), 78*o*-3(b)(6), 78s(g)(1), and 78cc(a); *McMahon*, 482 U.S. at 233-234; S. Rep. No. 75, 94th Cong., 1st Sess. 24 (1975) (noting that SROs "must exercise governmental-type powers if they are to carry out their responsibilities under the Exchange Act"). It is well established that "illegal promises will not be enforced in cases controlled by the federal law." *Kaiser Steel Corp.* v. *Mullins*, 455 U.S. 72, 77, 85-86 (1982). Accord *Quinn* v. *Gulf & Western Corp.*, 644 F.2d 89, 91 (2d Cir. 1981) (court would not enforce contract provision to pay contingent fee that violated federal procurement statute and regulation).[7] Rule 21(f)(4) would therefore preclude enforcement, with respect to agreements executed after its effective date, of a contractual provision that prevents arbitrators from awarding punitive damages when such damages would be available in a judicial forum in the relevant State.

The court of appeals' opinion reflects some confusion regarding the legal significance of the NASD Rules. The court stated, for example, that "[t]o the extent that [Rule 21(f)(4)] conflicts with New York law, the governing law of the agreement under all circumstances, we must conclude that the parties intended to be bound by New York law." Pet. App. 17. See also *id.* at 20 ("We resolve any apparent conflict between New York law and NASD rules in favor of New York law, the generally applicable law of the agreement."). With respect to contracts executed

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[7] This principle is subject to exceptions not relevant here. See, *e.g.*, *Olson* v. *Paine, Webber, Jackson & Curtis, Inc.*, 806 F.2d 731, 743 (7th Cir. 1986) (recognizing general principle that illegal contract terms will not be enforced, but enforcing contractual provision that violated a Commodity Futures Trading Commission (CFTC) regulation because to do so would not harm a party the regulation was intended to protect and failing to enforce the contract would "produce a sanction disproportionate to the wrong").

after September 7, 1989, that mode of analysis would clearly be wrong. Private parties have no authority to enter into contractual arrangements that are forbidden by federal law, or to agree that federal regulations will be superseded by contrary state law. To permit enforcement of such provisions in new brokerage agreements would undermine the ability of the NASD to carry out its responsibilities under the Exchange Act to adopt and enforce rules consistent with the Act to regulate the conduct of their member broker-dealer firms and associated persons. See 15 U.S.C. 78*o*-3(b)(6) (NASD Rules must be designed "to promote just and equitable principles of trade * * * and, in general, to protect investors and the public interest"); 15 U.S.C. 78s(g)(1). Cf. *City of New York* v. *FCC*, 486 U.S. 57 (1988).

The arbitration agreement at issue in the present case was executed in 1985, well before the promulgation of Rule 21(f)(4). This case therefore presents a question of contract interpretation, not of preemption by federal securities law. Regardless of the resolution of this case, however, it is important that the Court leave no confusion as to the operation of Rule 21(f)(4) with respect to agreements signed after the Rule's effective date.

## II. THE ARBITRATORS IN THIS CASE DID NOT EXCEED THEIR POWERS, AND VACATUR OF THE PUNITIVE DAMAGES AWARD WAS THEREFORE IMPROPER

### A. Under The Federal Arbitration Act, A Court Asked To Vacate An Arbitral Award Must Accord Substantial Deference To The Arbitrator's Construction Of The Governing Agreement

In reviewing arbitral decisions under the Labor-Management Relations Act, 1947, this Court has consistently made clear that "the question of interpretation of the collective bargaining agreement is a question for the arbitrator. It is the arbitrator's construction which was bargained for; and so far as the arbitrator's decision concerns construction of the contract, the courts have no business overruling him because their interpretation of the contract is different from his." *United Steelworkers of America* v. *Enterprise Wheel & Car Corp.*, 363 U.S. 593, 599 (1960). In *United Paperworkers Int'l Union, AFL-CIO*, v. *Misco, Inc.*, 484 U.S. 29 (1987), the Court recently reaffirmed that

> [b]ecause the parties have contracted to have disputes settled by an arbitrator chosen by them rather than by a judge, it is the arbitrator's view of the facts and of the meaning of the contract that they have agreed to accept. Courts thus do not sit to hear claims of factual or legal error by an arbitrator as an appellate court does in reviewing decisions of lower courts. * * * The arbitrator may not ignore the plain language of the contract; but the parties having authorized the arbitrator to give meaning to the language of the agreement, a court should not reject an award on the ground that the arbitrator misread the contract.

*Id.* at 37-38.

These principles are equally applicable to review of arbitral awards pursuant to the Federal Arbitration Act.[8] The Act does not empower a losing party to appeal the arbitrator's decision on grounds of legal error. Rather, the statute provides that the prevail-

[8] Indeed, this Court has noted that "the federal courts have often looked to the [Federal Arbitration] Act for guidance in labor arbitration cases." *Misco*, 484 U.S. at 40 n.9.

ing party may seek a judicial order confirming the award, "and thereupon the court must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title." 9 U.S.C. 9. Section 10(a) of the Act, 9 U.S.C. 10(a), *quoted at* Pet. 4-5, sets forth narrow grounds for vacatur of an award governed by the statute. Although this Court has not had occasion to address in detail the standards governing application of this provision,[9] the courts of appeals have repeatedly emphasized that the grounds for vacatur are to be narrowly construed and that a court may not refuse to confirm an award simply because it disagrees with the arbitrator's construction of the contract.[10]

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[9] In *Wilko* v. *Swan*, 346 U.S. 427 (1953), the Court observed that under the FAA "the interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation. The United States Arbitration Act contains no provision for judicial determination of legal issues such as is found in the English law." *Id.* at 436-437 (footnote omitted). The specific holding of *Wilko*—that predispute agreements to arbitrate claims under the Securities Act of 1933 are not enforceable—has since been overruled. See *Rodriguez De Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989). The Court has continued to recognize, however, that under the FAA "judicial scrutiny of arbitration awards necessarily is limited." *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 232 (1987).

[10] See, *e.g.*, *Davis* v. *Chevy Chase Financial Ltd.*, 667 F.2d 160, 165 (D.C. Cir. 1981); *Advest, Inc.* v. *McCarthy*, 914 F.2d 6 (1st Cir. 1990); *Andros Compania Maritima* v. *Marc Rich & Co., A.G.*, 579 F.2d 691, 704 (2d Cir. 1978); *Antwine* v. *Prudential Bache Sec., Inc.*, 899 F.2d 410, 413 (5th Cir. 1990); *Federated Dep't Stores* v. *J.V.B. Indus.*, 894 F.2d 862, 866 (6th Cir. 1990); *Flender Corp.* v. *Techna-Quip Co.*, 953 F.2d 273, 278 (7th Cir. 1992); *Lee* v. *Chica*, 983 F.2d 883, 885 (8th Cir. 1993); *French* v. *Merrill Lynch, Pierce, Fenner & Smith*, 784 F.2d 902, 906 (9th Cir. 1986).

There is, we acknowledge, some divergence among the circuits with respect to the standards governing vacatur of arbitral awards under the FAA. The courts of appeals have disagreed, for example, as to the propriety of vacatur on grounds other than those specified in Section 10(a). See generally *McIlroy* v. *PaineWebber, Inc.*, 989 F.2d 817, 820 & n.2 (5th Cir. 1993); *Brown* v. *Rauscher Pierce Refsnes, Inc.*, 994 F.2d 775, 779 & n.3 (11th Cir. 1993); Note, Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the "Manifest Disregard" of the Law Standard, 27 Ind. L. Rev. 241 (1993). For purposes of the instant case, however, those areas of disagreement are less important than is the uniform consensus that judicial review of an arbitral award under the FAA must reflect substantial deference to the arbitrator's construction of an ambiguous agreement. See *Davis*, 667 F.2d at 166 ("Although various tests have been employed in implementation of this broad standard, it is apparent that the arbitrator's award should not be upset in such a case if it represents a plausible interpretation of the contract.").



In the instant case the court of appeals acknowledged that "[t]he arbitrator's errors of law and contract construction are normally unreviewable under [9 U.S.C. 10(a)(4)]." Pet. App. 8. (Section 10(a)(4) states that an arbitral award may be vacated if, *inter alia*, the arbitrators "exceeded their powers.") The court asserted, however, that the "narrow scope of review does not immunize an award clearly unauthorized by the terms of the agreement." *Ibid.* That reasoning provides no basis for vacatur of the award in the instant case. In the first place, it is by no means apparent that even "clear" error in the interpretation of the contract constitutes a ground

for vacatur under Section 10(a).[11] In any event, as we explain in Point B, *infra*, there is no basis for the court of appeals' conclusion that the arbitral award of punitive damages was "clearly unauthorized" by the parties' agreement.

The court of appeals also asserted that "where the arbitrators are not entitled to award punitive damages due to a choice of law provision in the parties' agreement, it is 'manifest' that the arbitrators would exceed their powers by awarding punitive damages." Pet. App. 8-9 (quoting *Barbier* v. *Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991)). Although that language is not entirely clear, it appears to suggest that the question whether a contract authorizes the award of a discrete category of relief is to be resolved by the court de novo, on the theory that an arbitrator exceeds his powers by awarding a remedy that the agreement does not in fact permit. That

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[11] Compare *Ainsworth* v. *Skurnick*, 960 F.2d 939, 941 (11th Cir. 1992) ("although great deference is normally accorded an arbitration award, an award that is arbitrary or capricious is not required to be enforced"), cert. denied, 113 S. Ct. 1269 (1993) with *Hill* v. *Norfolk & W. Ry.*, 814 F.2d 1192, 1194-1195 (7th Cir. 1987) (under either the FAA or the labor statutes, "the question for decision by a federal court asked to set aside an arbitral award * * * is not whether the arbitrator or arbitrators erred in interpreting the contract; it is not whether they grossly erred in interpreting the contract; it is whether they interpreted the contract"). Cf. *AT&T Technologies* v. *Communications Workers*, 475 U.S. 643, 649-650 (1986) ("Whether 'arguable' or not, indeed even if it appears to the court to be frivolous, the union's claim that the employer has violated the collective-bargaining agreement is to be decided, not by the court asked to order arbitration, but as the parties have agreed, by the arbitrator.").



theory is contrary to this Court's precedents.[12] In *Enterprise Wheel* the Court considered a closely analogous question. The arbitrator in that case found that employees had been discharged in violation of the collective bargaining agreement; he ordered reinstatement and back pay extending beyond the expiration of the contract. The court of appeals vacated the award insofar as it provided relief for the period after the contract's expiration. This Court reversed. The Court observed that the agreement "could have provided that if any of the employees were wrongfully discharged, the remedy would be reinstatement and back pay up to the date they were returned to work." 363 U.S. at 598. The employer's attack on the arbitral award, the Court recognized, boiled down to the assertion that the contract, properly construed, did not so provide. *Ibid.* The Court rejected that contention, explaining that "[i]t is the arbitrator's construction which was bargained for; and so far as the arbitrator's decision concerns construction of the contract, the courts have no business overruling him because their interpretation of the contract is different from his." *Id.* at 599. That same principle applies here.[13]

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[12] Indeed, in the context of labor arbitration, this Court has emphasized that the arbitrator's discretion is particularly broad—and judicial interference with the exercise of that discretion particularly inappropriate—"when it comes to formulating remedies." *Misco*, 484 U.S. at 41 (quoting *Enterprise Wheel*, 363 U.S. at 597).

[13] Cf. *W.R. Grace & Co.* v. *Local Union 759, Int'l Union of the United Rubber Workers*, 461 U.S. 757, 765 (1983) ("Because the authority of arbitrators is a subject of collective bargaining, just as is any other contractual provision, the scope of the arbitrator's authority is itself a question of con-

Nor can a de novo standard of review be defended on the ground that "the question of arbitrability—whether a collective-bargaining agreement creates a duty for the parties to arbitrate the particular grievance—is undeniably an issue for judicial determination." *AT&T Technologies* v. *Communications Workers*, 475 U.S. 643, 649 (1986). The dispute here does not involve an issue of arbitrability. Rather, as the court of appeals correctly noted, "[t]he Client Agreement does not purport to withhold certain issues from arbitration. In fact, it refers all 'controvers[ies]' to arbitration." Pet. App. 18. The dispute concerns the legal framework governing the arbitrator's decision whether punitive damages should be awarded. Respondents contend that the choice-of-law clause, properly construed to incorporate the rule announced in *Garrity*, disentitled the arbitrator to award punitive damages under any circumstances. Possibly the arbitrators in this case could have construed the contract in that manner, although they did not. But, in any event, that contention concerning the meaning of the contract does not amount to a contention that petitioners' punitive damages claims are non-arbitrable. Cf. *AT&T Technologies*, 475 U.S. at 649 ("in deciding whether the parties have agreed to submit a particular grievance to arbitration, a court is not to rule on the potential merits of the underlying claims").

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tract interpretation that the parties have delegated to the arbitrator."). As we explain at pages 18-19, *infra*, questions concerning the scope of the arbitrator's authority with respect to matters conceded to be arbitrable must be distinguished from issues of arbitrability—*i.e.*, whether a particular claim is to be resolved by the arbitrator or by a court.



Indeed, any suggestion that petitioners' punitive damages claims are non-arbitrable would be fundamentally at odds with the basic premises underlying respondents' legal position. Petitioners initially filed suit in federal district court, including in their complaint a request for punitive damages. Respondents then moved to compel arbitration of the entire case, and the district court granted the motion. Pet. App. 3-4. Referral of the punitive damages claims to the arbitrators obviously served respondents' interests, since the incorporation of New York law into the parties' agreement could have posed no conceivable barrier to a punitive damages award if the issue had been adjudicated by the district court. Now that the arbitrators have concluded that the agreement did not in fact preclude an award of punitive damages, respondents may not evade that holding on the ground that the availability of such damages was not an arbitrable issue after all. Cf. *Willoughby Roofing & Supply Co.* v. *Kajima Int'l, Inc.*, 598 F. Supp. F. Supp. 353, 356-359 & n.12 (N.D. Ala. 1984), aff'd, 776 F.2d 269 (11th Cir. 1985).

### B. The Arbitrators Did Not Exceed Their Powers In Awarding Punitive Damages In This Case

For the reasons that follow, the courts below erred in concluding that the arbitrators had exceeded their powers in awarding punitive damages on petitioners' state law claims. In our view, the most persuasive reading of the agreement between the parties in this case is that an arbitral award of punitive damages is permitted where such relief would be available in a judicial forum. In any event, however, the arbitrators' construction of the governing contract as permitting punitive damages is surely a reasonable one, and is entitled to deference under the principles dis-

cussed in Point A, *supra*. The arbitral award therefore should have been confirmed.[14]

1. In construing an arbitration agreement within the coverage of the FAA, as with any other contract, the parties' intentions control. Those intentions are to be determined, however, by reading the agreement in light of the policies underlying the Act. See, *e.g.*, *Volt Info. Sciences* v. *Board of Trustees*, 489

[14] The Due Process Clause imposes two limitations on the amount of punitive damages that may be awarded in a judicial proceeding: a substantive ban on punitive damages that are "grossly excessive," *TXO Production Corp.* v. *Alliance Resources Corp.*, 113 S. Ct. 2711, 2718-2719 (1993) (plurality opinion); *id.* at 2731 (O'Connor, J., dissenting), and a procedural requirement that judicial review of the amount of punitive damages awards be available, see *Honda Motor Co.* v. *Oberg*, 114 S. Ct. 2331, 2335-2342 (1994). By executing an arbitration agreement governed by the FAA, however, a party consents to the limitations on judicial review established by 9 U.S.C. 10(a); "[i]t trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration." *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985). Enforcement of the parties' procedural bargain therefore raises no constitutional concerns.

It is far from clear, moreover, that the judicial review provided by Section 10(a) is in fact less extensive than the review required by the Constitution where punitive damages are awarded by a jury. An arbitrator who awards punitive damages in an amount that is "grossly excessive" within the meaning of the constitutional limitation recognized in *TXO Production* might well be said to have "exceeded [his] powers" under 9 U.S.C. 10(a)(4). An arbitrator would also be bound by any limitations on punitive damages that are imposed by the law that creates the claim. In the present case, the arbitrators awarded compensatory damages of approximately $160,000 and punitive damages of $400,000. Because respondents do not contest the size of the punitive damages award, the issue is not presented in this case.



U.S. 468, 475-476 (1989) ("in applying general state-law principles of contract interpretation to the interpretation of an arbitration agreement within the scope of the Act, due regard must be given to the federal policy favoring arbitration"). The Court has noted, for example, that in deciding the issue of arbitrability, "[t]he Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Moses H. Cone Memorial Hosp.* v. *Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983). Accord *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985); cf. *AT&T Technologies*, 475 U.S. at 650 ("where the [collective bargaining agreement] contains an arbitration clause, there is a presumption of arbitrability" with respect to a particular grievance).

Two aspects of federal policy under the FAA are of particular relevance here. First, this Court has repeatedly emphasized that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum." *Gilmer* v. *Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26 (1991); *McMahon*, 482 U.S. at 229-230; *Mitsubishi*, 473 U.S. at 628.[15] Second, the Court has stressed that the pur-

[15] The principle that the decision to arbitrate is not a surrender of substantive rights that would be available in a judicial forum also underlies NASD Rule of Fair Practice 21(f)(4). As the Commission's Approval Order put it, Rule 21(f)(4) "makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes represents solely a choice of arbitration as a means of dispute resolution," not a decision to surrender "any rights that a party may other-

pose of the FAA "was to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts." *Gilmer*, 500 U.S. at 24. This Court has thus explained that "[w]e are well past the time when judicial suspicion of the desirability of arbitration and the competence of arbitral tribunals inhibited the development of arbitration as an alternative means of dispute resolution." *Id.* at 34 n. 5 (quoting *Mitsubishi*, 473 U.S. at 628). See also *id.* at 30 (noting that generalized attacks on submitting statutory claims to arbitration "'res[t] on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants,' and as such, they are 'far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes'") (quoting *Rodriguez De Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477, 481 (1989)). Accord *McMahon*, 482 U.S. at 231-234.

For a court, as a basis for vacating an arbitration award, itself to construe an ambiguous arbitration agreement as incorporating the rule announced in *Garrity* would be contrary to both of the foregoing principles. The *Garrity* court reasoned that "[t]he evil of permitting an arbitrator whose selection is often restricted or manipulatable by the party in a superior bargaining position, to award punitive damages is that it displaces the court and the jury, and therefore the State, as the engine for imposing a social sanction." 353 N.E.2d at 796. As the Seventh Circuit itself recognized in an opinion subsequent to its decision in this case, *Garrity* is based in large

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wise have had in a judicial forum." 1989 Release, 54 Fed. Reg. at 21,154.



part on the "mistrust of arbitrators" that this Court has emphatically rejected. See *Baravati* v. *Josepthal, Lyon & Ross, Inc.*, 28 F.3d 704, 710-711 (7th Cir. 1994). The necessary consequence of the *Garrity* rule, moreover, is that execution of an arbitration agreement entails not simply consent to an alternative forum, but a waiver of substantive rights as well. Insofar as the FAA is concerned, the parties are assuredly *permitted* to agree to such constraints on the arbitrator's remedial power, just as they are permitted to fashion an arbitration agreement that reserves most potential disputes for judicial resolution. Because such contractual terms run counter to the premises underlying the FAA, however, they should not be inferred by the courts absent an unambiguous indication that this was the parties' intent.

2. For the reasons that follow, no such clear statement is present in this case.

a. The court of appeals asserted that "the parties agreed to arbitrate all of their controversies under New York law," Pet. App. 12, and that "[s]ubmission to New York law is a general condition upon the arbitration of all 'controvers[ies]' between the parties." *Id.* at 13-14. The agreement provides that it "shall be governed by the laws of the State of New York," *id.* at 44, and presumably New York law defines the rights and obligations established by the contract itself. It is clear, however, that New York law was not intended to govern every aspect of all disputes between the parties. Respondents do not contend, for example, that the arbitrator was required to apply New York law in ruling on petitioners' claims under the Securities Exchange Act or SEC Rule 10b-5. Petitioners also asserted claims based upon Illinois and Texas statutes, see Pet. App.

4, and neither of the courts below suggested that those claims were barred by the choice-of-law provision. Although the agreement was to be "governed" by the law of New York, it was plainly within the contemplation of the parties that other sources of law might be consulted in the process of resolving any disputes that might arise.

b. In this case, the arbitration agreement not only contained the New York choice-of-law provision, but it also provided that arbitration would be conducted "in accordance with the rules then in effect, of the [NASD]." Pet. App. 44. The NASD Code of Arbitration Procedure does not restrict the types of relief an arbitrator may award, but merely refers to "damages and other relief." NASD Code of Arbitration Procedure, Section 41(e) (*quoted at* Pet. App. 15). See *Gilmer*, 500 U.S. at 30 (suggesting that nearly identical language in New York Stock Exchange Rules allows a broad range of types of relief); see also *Baravati*, 28 F.3d at 710 ("Silence [about the scope of arbitrators' powers] implies—given the tradition of allowing arbitrators flexible remedial discretion—the absence of categorical limitations."). As the court of appeals in the instant case acknowledged, moreover, the NASD Manual for arbitrators specifically advises that punitive damages are a permissible remedy. Pet. App. 15.

The court of appeals acknowledged that the pertinent provisions of the Code and Manual are at least to some extent inconsistent with *Garrity*. The court resolved that tension by treating the New York law provision as the most significant provision in the agreement and then using it to trump the NASD rules. There is, in our view, no warrant in the language of the contract for concluding that the arbitrators were compelled to adopt that approach. Both the choice-of-law provision and the provision incorporating NASD rules identify bodies of law that are to be relied on in settling disputes between the broker-dealer and its customers. One provision may not be read out of the agreement when there is a reasonable interpretation of the paragraph that accommodates both.



Indeed, in our view, these provisions are most reasonably harmonized by applying New York law to determine what substantive rights and obligations are created by the contract, while applying NASD rules to resolve questions concerning the conduct of the arbitral proceedings and the scope of the arbitrators' authority. That reading comports with the established principles of contract interpretation that different provisions of an agreement should be read as consistent with each other if that is reasonably possible, that an interpretation giving effect to all the terms is preferred to one which leaves some of no effect, and that the specific (*i.e.*, NASD rules applicable to arbitration) prevails over the general (*i.e.*, the provision referencing New York law). See, *e.g.*, Restatement (Second) of Contracts § 202(5) & Cmt. d (reading different provisions as consistent with each other); *id.* § 203(a) & Cmt. b (giving effect to all terms); *id.* § 203(c) & Cmt. e (specific over general) (1981).[16]

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[16] Moreover, it is well established that in choosing among the reasonable meanings of the terms of an agreement, "that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds." Restatement (Second) of Contracts § 206. The contract here is a form agreement drafted by respondents.

In any event, as we have explained (see pages 12-19, *supra*), the dispositive point is that the task of harmonizing apparently inconsistent contractual provisions is the province of the arbitrator rather than the courts. For the reasons explained in the preceding paragraph, the arbitrators in this case acted well within their province.

c. If the agreement in this case had contained no choice-of-law provision, the arbitrators would presumably have assessed the parties' rights and obligations under the contract by reference to the law of some State, chosen on the basis of its connection to the parties, the agreement, and the contested transactions. If that State had been New York, however, it seems clear that the *Garrity* rule would not have been applied. State law is preempted "to the extent that it actually conflicts with federal law—that is, to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" *Volt*, 489 U.S. at 477 (quoting *Hines* v. *Davidowitz*, 312 U.S. 52, 67 (1941)).[17] The *Garrity* rule, which is premised on the mistrust of arbitrators that the FAA was intended to counteract,

[17] For example, the FAA "pre-empts state laws which 'require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.'" *Volt*, 489 U.S. at 478 (quoting *Southland Corp.* v. *Keating*, 465 U.S. 1, 10 (1984)); *Perry* v. *Thomas*, 482 U.S. 483, 489-490 (1987). Similarly, States may not impose conditions on arbitration agreements that are not imposed generally on other types of contracts. *Saturn Distribution Corp.* v. *Williams*, 905 F.2d 719, 723-724 (4th Cir.), cert. denied, 498 U.S. 983 (1990); *Securities Industry Assoc.* v. *Connolly*, 883 F.2d 1114, 1120 (1st Cir.), cert. denied, 495 U.S. 956 (1990); *Webb* v. *R. Rowland & Co.*, 800 F.2d 803, 806-807 (8th Cir. 1986).



and which treats arbitration as a disfavored forum, surely stands as an obstacle to the effective implementation of the congressional purpose. As the Seventh Circuit recently noted, "[s]tate common law hostile to arbitration is preempted by federal common law friendly to it." *Baravati*, 28 F.3d at 711.

So far as the FAA is concerned, "parties are generally free to structure their arbitration agreements as they see fit," and they may limit by contract such matters as the issues they will arbitrate or the rules under which the arbitration will be conducted. *Volt*, 489 U.S. at 479. The Act therefore would not prevent the parties from expressly agreeing that punitive damages would not be awardable in any dispute between them, or from accomplishing the same result by inserting explicit contractual language to the effect that resolution of disputes between the parties "will be governed by New York law, including the limitation on arbitral power announced in *Garrity*." But the customer agreement here does not expressly say that punitive damages are not allowed, nor does it reference the *Garrity* rule; it says only that New York law governs. Standing alone, the choice-of-law provision should not be read to incorporate state law principles that would be preempted if New York law applied of its own force as a result of the State's connection to the relevant primary conduct.[18]

[18] This Court's decision in *Volt* is not to the contrary. The arbitration agreement at issue in *Volt* included a choice-of-law provision that referenced California law. Because the California Arbitration Act authorized "a court to stay arbitration pending resolution of related litigation" (489 U.S. at 470), the case had proceeded directly in the state courts, rather than on review of an arbitral award. The California Court of Appeal interpreted the choice-of-law provision to incorporate California rules of arbitration, including the statu-

d. For the foregoing reasons, the arbitrators in this case acted well within their province in interpreting the parties' agreement as not incorporating the *Garrity* rule. The courts below therefore erred in setting aside the award of punitive damages.

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tory provision empowering a state trial court to stay arbitration. *Id.* at 471-472. This Court declined to revisit the state court's construction of the arbitration agreement, *id.* at 474-476, noting that "the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review." *Id.* at 474. The Court then held that, "assuming the choice-of-law clause meant what the Court of Appeal found it to mean," *id.* at 476, application of the stay provision was not preempted by the FAA. *Id.* at 476-479.

*Volt* does not cast doubt upon our contention that the agreement in the instant case was permissibly interpreted by the arbitrators to allow an award of punitive damages. Nothing in *Volt* suggests that respondents' construction of the agreement here is the correct one, much less that an arbitral award grounded in a contrary reading was properly vacated by the district court. Moreover, the California procedural rules at issue in *Volt* merely provided that the trial court could coordinate the timing of an arbitration proceeding and a parallel state court lawsuit involving third parties. This Court found that incorporation of the California procedural rules was not inconsistent with the FAA because those rules were "manifestly designed to encourage resort to the arbitral process." 489 U.S. at 476. In contrast to the state procedural rules applied in that case, the *Garrity* rule discourages resort to the arbitral process by depriving plaintiffs of an otherwise available substantive remedy.



## CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

ANTONIO C. MASTROBUONO and
DIANA G. MASTROBUONO,
*Petitioners,*

v.

SHEARSON LEHMAN HUTTON INC.,
a corporation, and NICK DIMINICO,
*Respondents.*

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

# BRIEF OF RESPONDENTS

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## QUESTIONS PRESENTED

Whether the court of appeals correctly interpreted the arbitration agreement at issue in this case as precluding the arbitrators from awarding punitive damages.

Whether the court of appeals correctly interpreted the arbitration agreement at issue in this case as precluding petitioners from asserting an independent "claim" for punitive damages in court.

## LIST OF PARTIES

Petitioners:

Antonio C. Mastrobuono

Diana G. Mastrobuono

Respondents:

Lehman Brothers Inc. (Lehman Brothers Inc. is the successor corporation to the corporation that was formerly known as Shearson Lehman Hutton Inc.).

Nick DiMinico

Richard F. Benzer and Mark Stevenson were not appellees in the court below and are not parties herein

The following is furnished in compliance with Supreme Court Rule 29.1:

Lehman Brothers Inc.
Parent Company — Lehman Brothers Holdings Inc.
Subsidiaries (except wholly owned) — None



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**IN THE**
**SUPREME COURT OF THE UNITED STATES**

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**OCTOBER TERM, 1994**

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**No. 94-18**

ANTONIO C. MASTROBUONO, ET AL., PETITIONERS

v.

SHEARSON LEHMAN HUTTON INC., ET AL.

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On Writ of Certiorari to the United
States Court of Appeals for the Seventh Circuit

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# BRIEF OF RESPONDENTS

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## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 20 F.3d 713, and is reproduced in the Appendix to the Petition for a Writ of Certiorari ("Petition") at App. 1-27. The opinion of the United States District Court for the Northern District of Illinois is reported at 812 F. Supp. 845, and is reproduced in the Appendix to the Petition at App. 28-43.

## JURISDICTION

The judgment of the court of appeals was entered on March 30, 1994. The Petition was filed on June 28, 1994 and was granted on October 7, 1994. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

## STATUTORY PROVISIONS INVOLVED

The relevant provisions of the following statutes are set forth in the Appendix hereto:

9 U.S.C. § 3
9 U.S.C. § 4
9 U.S.C. § 10(a)(4)

## STATEMENT OF THE CASE

In October 1985, petitioners Antonio C. and Diana G. Mastrobuono signed a Client Agreement with Shearson Lehman Hutton Inc. ("Shearson"), a registered broker-dealer now known as Lehman Brothers Inc. (R. 59, ¶ 2 & Ex. A). Paragraph 13 of that Client Agreement specifies that New York law governs, and contains an arbitration provision:

> This agreement . . . shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [petitioners'] accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as I may elect.



(R. 59, Ex. A).

At the time petitioners executed the Client Agreement and throughout the duration of their account at Shearson, petitioners were residents of Illinois. Antonio Mastrobuono was a college professor and his wife, Diana, was an artist and homemaker. Shearson at all relevant times was a Delaware corporation with its principal place of business in New York. Petitioners conducted their investment transactions at Shearson through Nick DiMinico, a broker employed in Shearson's Houston, Texas branch office. (R. 1, ¶¶ 5-7).

After opening their account at Shearson in October 1985, the petitioners realized trading profits of approximately $125,000 through March 1987. However, after their refusal to meet margin calls precipitated by the October 1987 stock market crash, their remaining investment positions were liquidated, resulting in an alleged out of pocket loss of approximately $65,000. (R. 81, Ex. D, Answer at 8; *see* R. 1, ¶ 59).

On January 30, 1989, petitioners filed an action in the United States District Court for the Northern District of Illinois against Shearson, Nick DiMinico, and others who were subsequently dismissed. (R. 1). Petitioners alleged in that complaint that respondents

had made certain misrepresentations in connection with their investments, that their account had been churned, and that their signatures on the Client Agreement were forgeries thereby negating any obligation to arbitrate their dispute. *(Id.)*.

The complaint alleged claims based upon the Securities Exchange Act of 1934, the Racketeer Influenced and Corrupt Organization Act, the Illinois Securities Law, the Illinois Consumer Fraud and Deceptive Practice Act, breach of contract, breach of fiduciary duty, fraud, misrepresentation and negligence. The Complaint sought for each claim compensatory damages comprised of direct out of pocket losses of $64,184, accountants' fees of $2,000, taxes paid of $20,000 and unspecified interest; treble damages under the RICO claim; and $2,000,000 in punitive damages under the state and common law claims, except the negligence claim. (R. 1 at pp. 19-22). No punitive damages were sought under the federal claims. *(Id.)*.

In April 1989, respondents moved for an order to enforce the Client Agreement's arbitration provision in accordance with its terms pursuant to Sections 3 and 4 of the Federal Arbitration Act ("FAA"), 9 U.S.C. § 1 *et seq*. (R. 22-23). Discovery ensued with respect to petitioners' allegations that the Client Agreement had been forged. (R. 20). Experts employed by both petitioners and respondents concluded, and the district court found, that the Client Agreement had been signed by both of the petitioners, and the court ordered that the parties proceed to arbitration before



the National Association of Securities Dealers, Inc. ("NASD").[1] (R. 38, 48).

Petitioners filed their Statement of Claim with the NASD on October 20, 1989, making the same claims as in their district court complaint. Thereafter, petitioners filed an Amended Statement of Claim on September 16, 1991, asserting violations of the NASD Rules of Fair Practice, SEC Rule 10b-5, § 15c(1) of the Securities Exchange Act, the Illinois Consumer Fraud Act, the Texas Deceptive Trade Practices Act, and common law claims for breach of fiduciary duty and negligence. (R. 81, Ex. D). Petitioners sought compensatory damages of $199,216 consisting of commissions, mark-ups, other sales charges, and margin interest; treble damages under the Texas Deceptive Trade Practices Act; and punitive damages of $2,000,000. *(Id.*, Ex. D, ¶¶ 16-17).

The arbitration hearings were held before a panel of three arbitrators on August 11 and 12, 1992, and September 29, 1992 in Chicago, Illinois. (R. 59, Ex. D). Respondents submitted a Memorandum Regarding Claim For Punitive Damages to the arbitrators on September 29, 1992, setting forth respondents' position that the New York choice-of-law provision in the Client Agreement precluded the arbitrators from awarding punitive damages. (R. 59, Ex. B). Petitioners submitted a responsive memorandum to the arbitrators on October 6, 1992, contending, *inter alia*, that the arbitrators were not bound to follow either the "letter of the law" or the

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[1] Subsequently, the district court entered sanctions against petitioners of over $3,000 for having made the forgery allegations. (R. 47-48).

"letter of . . . the parties agreement." Their memorandum stated:

> This panel can and should do justice for the parties and apply the rules of law and equity as the arbitrators see them. The panel's decision should reflect the spirit rather than the letter of the law and of the parties agreement.

(R. 59, Ex. C at 2).

On October 13, 1992, the arbitrators issued a written award granting petitioners compensatory damages in the amount of $115,274 in commissions and $44,053 in margin interest, plus $400,000 in punitive damages. (R. 59, Ex. D at 4). The arbitrators' Award stated that their authority for the award of punitive damages was to be found in the above-cited petitioners' memorandum dated October 6, 1992. (*Id.*).

On November 5, 1992, respondents moved the district court for an order vacating the award of punitive damages pursuant to Section 10(a)(4) of the FAA, which permits a court to vacate an award "[w]here the arbitrators exceeded their powers. . . . " 9 U.S.C. § 10(a)(4). (R. 58). The motion was based upon the New York choice-of-law provision in the Client Agreement. On December 11, 1992, petitioners moved the district court for an order confirming the award of punitive damages, or in the alternative, for a trial on the amount of punitive damages to be awarded, or as a further alternative, for a trial on their alleged claims for punitive damages. (R. 68).



The district court vacated the award of punitive damages under 9 U.S.C. § 10(a)(4), finding that punitive damages are not an available remedy where an arbitration agreement is governed by New York law. The court specifically relied on the similar conclusions reached by the Courts of Appeals for the Second and Seventh Circuits. 812 F. Supp. at 847 (citing *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117 (2d Cir. 1991), and *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334, 337-39 (7th Cir. 1984)). The district court further relied upon this Court's decision in *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468 (1989), in concluding that "enforcing an arbitration agreement's choice-of-law provision in accordance with the terms of that agreement is fully consistent with the goals of the FAA." 812 F. Supp. at 847.

The district court also denied petitioners' motion to have the court itself award punitive damages, finding that by operation of the New York choice-of-law provision the petitioners had agreed that the "damages available to them would be those awardable by arbitration under New York law." *Id.* at 848. Furthermore, the court concluded that both Illinois and New York law preclude a separate cause of action solely for punitive damages. *Id.*

The court of appeals affirmed the district court's opinion, concluding in reliance upon *Volt* that the federal policy embodied by the FAA "is simply to ensure the enforceability, *according to their terms*, of private agreements to arbitrate." 20 F.3d at 716 (emphasis in original).

The court of appeals also held: (1) that Illinois law would enforce the New York choice-of-law because there was in fact a relationship between New York

and the parties, *i.e.*, Shearson's principal place of business; and (2) that New York law was not contrary to the public policy of Illinois, which itself recognizes that punitive damages may not be awarded in arbitration unless the parties have expressly agreed to the arbitrator's authority to do so. *Id.* at 719.

The court of appeals also rejected the argument that the district court should have severed the punitive damages claims for trial, finding that under the "plain language of the agreement, the plaintiffs are entitled only to the damages available in arbitration under New York law." *Id.* at 718.

Finally, the court of appeals held that petitioners' argument that a predispute waiver of punitive damages in arbitration is void under the public policies of Texas and Illinois was waived because it had not been raised in the district court. *Id.* at 719.

## SUMMARY OF ARGUMENT

This case concerns only the meaning of an arbitration agreement, not whether the agreement is in conflict with or preempted by the FAA or the federal securities laws. The FAA requires federal courts to enforce arbitration agreements according to their terms. That principle was emphatically affirmed by this Court in *Volt*, in which the choice-of-law clause in the arbitration agreement, as construed, required the application of a California statute that ran counter to the otherwise applicable federal law governing stays of arbitration. The Court held that the terms of the arbitration agreement containing the choice-of-law clause prevailed. The Government as *amicus curiae* concedes that the FAA permits an arbitration



agreement to withhold from the arbitrators the power to award punitive damages. The only question is whether the agreement in this case did so.

The issue of contract interpretation turns on the effect to be given to the choice-of-law clause in the Client Agreement involved in this case. The provision specified that New York law should apply. Under New York law, arbitrators have no power to award punitive damages. *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976). Both lower courts in this case held that the choice-of-law clause incorporated the *Garrity* rule. That conclusion is clearly correct, because there is no plausible basis for finding that a choice-of-law provision does not incorporate the chosen state's law concerning remedies as fully as its law concerning the rights and duties of the parties. There is no more reason why the provision needed to make specific reference to the *Garrity* rule than to any other particular rule of New York law, and nothing in the FAA requires giving choice-of-law provisions a different interpretation or effect than they would have if the Act did not apply.

The conclusion required by the choice-of-law clause is consistent with all other provisions of the arbitration agreement at issue, including the provision specifying that the rules of the NASD will govern the arbitration. Nothing in those rules can be construed as giving arbitrators the power to award punitive damages; the NASD rules are silent on the remedial powers of the arbitrators.

It is argued by the Government as *amicus*, but not by petitioners, that § 10(a)(4) of the FAA does not permit a court asked to vacate an award to make its own determination whether the arbitrators "exceeded their powers" but instead requires the court to defer to

the arbitrators' reasonable interpretation of the contract even as to the question of their own power. Even if that were a correct view of § 10(a)(4), it could not be followed in this case because the arbitrators did not interpret the provisions of the contract as giving them power to award punitive damages, but merely based that power on "the spirit rather than the letter of the law and of the parties' agreement." (R. 59, Ex. C at 2).

The narrow view of a court's responsibility under § 10(a)(4) that the Government suggests is at odds with the approach of every court of appeals that has considered the punitive damages issue raised by this case. All of those cases assumed that the *court* should decide the question whether arbitrators "exceeded their powers," rather than defer to the views of the arbitrators. The Government's view would assimilate the question whether arbitrators "exceeded their powers" to every other question of contract interpretation. It would effectively eviscerate § 10(a)(4)'s obvious purpose to treat the "powers" of arbitrators as a distinct issue, to be determined by the court rather than the arbitrators themselves, just as is true with respect to the question whether a particular issue is arbitrable. The courts that have dealt with the question of punitive damages have correctly treated the question as one for the court to decide, and the lower courts in this case were required by § 10(a)(4) to vacate the award upon determining that the arbitration agreement conferred no power on the arbitrators to award punitive damages. But even if courts were required to defer to the arbitrators' "reasonable" views of their own powers, that would not aid the petitioners, since no reasonable interpretation



of the agreement involved in this case would permit the arbitrators to award punitive damages.

The arbitration agreement did not effect a "waiver" of rights to punitive damages. Petitioners' "rights" were only those defined in the agreement itself, as the Court held in *Volt* with respect to a similar argument. Petitioners' argument is in effect an argument that the choice-of-law clause was invalid on the ground of unconscionability. There are no facts in the record to support such a contention. The Court has consistently rejected arguments that clauses in standard commercial contracts are to be disregarded merely because of the alleged unsophistication of one of the parties or their allegedly unequal bargaining power. Petitioners' alternative contention that the district court should have independently tried the issue of punitive damages is equally without merit, for the same reasons and for the additional reason that petitioners are unable to point to any applicable law that creates a "claim" for punitive damages independent of an underlying cause of action for compensatory damages. All of petitioners' "claims" were required to be arbitrated in accordance with the terms of the arbitration agreement.

## ARGUMENT

### I. THE FEDERAL ARBITRATION ACT REQUIRES ENFORCEMENT OF THE PARTIES' AGREEMENT TO ARBITRATE ACCORDING TO ITS TERMS AND SUCH AN AGREEMENT MAY PRECLUDE AN AWARD OF PUNITIVE DAMAGES.

The only question that this case presents, and the question that is determinative under the FAA, is how the agreement at issue should be construed.

This Court has repeatedly said that the purpose of the FAA is simply to require the enforcement, according to their terms, of arbitration agreements that are within the purview of the Act. *See Volt Info. Sciences, Inc.*, 489 U.S. at 478; *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 625-26 (1985). As this Court summarized in *Dean Witter*:

> The legislative history of the Act establishes that the purpose behind its passage was to ensure judicial enforcement of privately made agreements to arbitrate. . . . The Act, after all, does not mandate the arbitration of all claims, but merely the enforcement — upon the motion of one of the parties — of privately negotiated arbitration agreements.
>
> * * *



> [P]assage of the Act was motivated, first and foremost, by a congressional desire to enforce agreements into which parties had entered, and we must not overlook this principal objective when construing the statute. . . .

470 U.S. at 219-20 (footnote omitted). *See id.* at 220 n.7 (The Act "'creates no new legislation, grants no new rights, except a remedy to enforce an agreement in commercial contracts and in admiralty contracts'" (quoting 65 Cong. Rec. 1931 (1924)); *Volt Info. Sciences, Inc.*, 489 U.S. at 476 ("There is no federal policy favoring arbitration under a certain set of procedural rules: the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.").

A major portion of petitioners' brief is devoted to the argument that "The FAA Preempts State Law Prohibitions Against Arbitral Awards Of Punitive Damages." Pet. Br., Point I, pp. 17-58. The proposition is simply incorrect. Enforcement of the terms of an arbitration agreement that withholds from the arbitrators the power to award punitive damages is entirely consistent with the FAA. Petitioners' argument to the contrary finds no support in any of the numerous cases of this Court discussed in their brief. And there is no basis for finding in the FAA any policy either affirmatively favoring punitive damages or forbidding parties to an arbitration agreement from choosing state law that precludes punitive damages or determines their substantive rights in any other way.

Petitioners cite cases from this Court that identify the strong federal policy favoring arbitration, which requires that state laws must not *interfere* with

the parties' agreement to arbitrate. By contrast, here the agreement *incorporates* the challenged state law, making that law and the agreement one and the same. Ignoring this fundamental difference between the cases they cite and this case, petitioners argue that the FAA requires that arbitration agreements be interpreted to provide an arbitrator with greater authority than the agreement itself supplies. This Court has never held that. None of the cases decided by this Court has held, under the guise of federal preemption, that either party to an arbitration contract shall be entitled to greater rights than they would be entitled to if their agreed choice of law were enforced according to its terms. Such a result is contrary to the express purpose of the FAA.

Since the FAA requires enforcement of the designation of New York law in the parties' agreement, the FAA mandates enforcement, not preemption, of the New York rule of *Garrity v. Lyle Stuart, Inc.*, *supra*, in this case. An issue of preemption under the FAA could arise only if enforcement of state law prevented enforcement of the agreement. *Cf. Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 710-11 (7th Cir. 1994); *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir.), *cert. denied*, ___ U.S. ___, 112 S. Ct. 380 (1991), and *cert. denied*, ___ U.S. ___, 112 S. Ct. 1241 (1992). No such issue is present in this case; the state law *is* the agreement.

Contrary to the position asserted by petitioners, the *amicus* brief of the United States and the SEC (hereafter referred to as "SEC Br.") acknowledges that "[s]o far as the FAA is concerned, 'parties are generally free to structure their arbitration agreements as they see fit'" (quoting *Volt*) and may



"limit by contract such matters as the issues they will arbitrate or the rules under which the arbitration will be conducted." SEC Br. 27. The Government's concession is clearly correct.

The controlling effect of the parties' agreement is forcefully illustrated by the decision in *Volt*. Four years before *Volt*, the Court rejected the "intertwining doctrine" and held that the FAA requires immediate arbitration of arbitrable claims notwithstanding the potential impact of such arbitration on the resolution of related but nonarbitrable claims. *Dean Witter Reynolds Inc. v. Byrd*, *supra*. In *Volt*, however, the parties agreed through a choice-of-law clause to incorporate California law in the arbitration agreement, and that was sufficient to override any such requirement of the FAA. The result was to permit a stay of arbitration, pursuant to California law, pending the outcome of related court proceedings (a result probably the equivalent of denying arbitration entirely, since the litigation would in all probability decide the disputed issues). The Court reached that result even though it assumed for purposes of the decision that §§ 3 and 4 of the Act are fully applicable in state court proceedings. *See* 489 U.S. at 476-77. Thus, the agreement of the parties in *Volt*, expressed by a choice-of-law clause, made applicable a state law rule that prevented an arbitration from going forward pursuant to otherwise applicable federal law — an effect more drastic than in this case.

Viewed from this perspective, whether New York's *Garrity* rule is "hostile" to arbitration misses the mark. Rather, enforcing the parties' selection of New York law, with its incorporation of *Garrity*, is the

only way to ensure a result that is compatible with the FAA.

Finally, it is also clear in this case that there is no preemption of state law, and no basis for invalidating the parties' agreement, because of anything in the federal securities laws, which do not even permit the award of punitive damages. *See* 15 U.S.C. § 78bb(a). The SEC suggests that as to customer agreements with broker-dealers entered into after September 7, 1989, the result reached in this case would be changed by Rule 21(f)(4) of the NASD Rules of Fair Practice. SEC Br. 10-12. Whatever the merits of that contention, the issue is not presented here. As the SEC concedes, Rule 21(f)(4) does not apply to the customer agreement in this case, which was executed in 1985; therefore "[t]his case . . . presents a question of contract interpretation, not of preemption by federal securities law." *Id.* at 12.[2]

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[2] Respondents agree with and adopt the arguments of *amicus curiae* Securities Industry Association that Rule 21(f)(4) is not intended to preclude NASD member firms from designating the applicable state law in their customer agreements, even when that state law has the effect of limiting remedies available in arbitration. Respondents also urge the Court to decline the SEC's request for an advisory opinion concerning the effect of Rule 21(f)(4) on customer agreements executed after September 7, 1989. The issue is not relevant to this case, was never raised below and is not urged by petitioners here. The SEC does not claim that the issue has been addressed in the lower courts, and the issue should not be decided in the first instance in this case on the basis of brief argument by an *amicus curiae*. *See United Parcel Service, Inc. v. Mitchell*, 451 U.S. 56, 60 n.2 (1981); *Bell v. Wolfish*, 441 U.S. 520, 532 n.13 (1979); *Knetsch v. United States*, 364 U.S. 361, 370 (1960).



## II. THE ARBITRATION AGREEMENT AT ISSUE WITHHOLDS FROM THE ARBITRATORS THE POWER TO AWARD PUNITIVE DAMAGES.

### A. The Choice-Of-Law Clause, By Definition, Includes New York's *Garrity* Rule.

The agreement in this case must be read in a manner consistent with the normal function and meaning of choice-of-law clauses. Nothing in the FAA or in any of this Court's decisions under the Act suggests that there is any federal policy that is hostile to choice-of-law clauses or that justifies selectively excising legal rules that would normally be within the ambit of a choice-of-law clause. To the contrary, this Court's decision in *Volt* shows that the FAA is entirely compatible with choice-of-law clauses and permits giving them comprehensive effect. As the Court said with respect to the arbitration clause in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, there is "no reason to distort the process of contract interpretation" or "color the lens through which the arbitration clause is read" (473 U.S. 614, 627-28 (1985)) in deciding what a choice-of-law clause means.

The function of a choice-of-law clause is to substitute the parties' designation of the applicable law for the choice-of-law rules that a court would apply in the absence of such a choice. The accepted view is that the parties have wide autonomy in making such a designation, and that the law of the chosen state will apply to any issue if the issue "is one which the parties could have resolved by an explicit provision in their agreement directed to that issue."

Restatement (Second) of Conflicts of Laws § 187(1) (Supp. 1988) ("Restatement").

For the reasons already stated, it is beyond dispute that the parties could have withheld from the arbitrators the power to award punitive damages through an explicit prohibition in the agreement. The Government's brief is clear on this point:

> The Act therefore would not prevent the parties from expressly agreeing that punitive damages would not be awardable in any dispute between them, or from accomplishing the same result by inserting explicit contractual language to the effect that resolution of disputes between the parties "will be governed by New York law, including the limitation on arbitral power announced in *Garrity*." (SEC Br. 27.)

Since the issue *is* one that the parties could have resolved by explicit agreement "directed to that issue," the choice-of-law clause accomplishes its normal function by making unnecessary an "explicit provision in their agreement directed to that issue." Otherwise, there would be no need for, and no purpose to be served by, the general designation of "New York law." As the Restatement points out, the rule recognizing choice-of-law agreements rests on the principle of incorporation by reference:

> The rule of this Subsection [§ 187(1)] is a rule providing for incorporation by reference and is not a rule of choice of law. The parties, generally speaking,



> have power to determine the terms of their contractual engagements. They may spell out these terms in the contract. In the alternative, they may incorporate into the contract by reference extrinsic material which may, among other things, be the provisions of some foreign law. In such instances, the forum will apply the applicable provisions of the law of the designated state in order to effectuate the intentions of the parties. So much has never been doubted. (Restatement § 187(1) *Comment c.*)[3]

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[3] There may be issues that the parties are not allowed to resolve by a choice-of-law clause, where the law of a chosen state is contrary to a fundamental policy of a state with a greater interest in the issue. *See* Restatement § 187(2). It is only on that principle that the laws of other states might apply, if they differed from the law of the chosen state. The fact that in this case petitioners "asserted claims based upon Illinois and Texas statutes" says nothing about the intended effect or proper meaning of the choice-of-law clause, as the SEC brief attempts to suggest. SEC Br. 23-24. As the court of appeals found, Illinois, the forum state in this case, clearly has no fundamental policy contrary to New York law with respect to the power of arbitrators to award punitive damages. *See Edward Elec. Co. v. Automation, Inc.*, 229 Ill. App. 3d 89, 104-05, 593 N.E.2d 833, 843, 171 Ill. Dec. 13, 23 (1st Dist.), *app. denied*, 146 Ill. 2d 625, 602 N.E.2d 450, 176 Ill. Dec. 796 (1992) (Punitive damages may not be awarded in arbitration unless "the parties have expressly agreed to the arbitrators' authority to award punitive damages."). 20 F.3d at 719.

As to federal law, it is not the function of choice-of-law clauses to attempt to designate state law in preference to federal law; the rule set forth above, and the well-recognized function of choice-of-law clauses relates to the choice among conflicting and

The principle of incorporation by reference would be useless if, in addition to incorporating by reference, a choice-of-law clause were required to identify specifically each rule of law meant to be adopted by the reference.

There is no requirement that the parties have any specific intention with respect to any rule of the chosen body of law, or even that they be aware of specific rules. It is enough that they have agreed that a designated body of law will be looked to in resolving disputes. To require more would mean that the parties would have to know and have in mind all rules of law that might conceivably apply to any dispute that might arise between them and to make a conscious selection among such rules — an obviously impracticable task. Any such requirement would destroy any reason for having a choice-of-law clause, the very object of which is to enable parties to adopt a *body* of law, rather than specifying detailed rules or being forced to rely on the vagaries of the law applied by whatever court or other forum called upon to decide the dispute or on the uncertainties of conflict-of-law principles applied by such a forum.

After acknowledging that the agreement in this case *could* have incorporated the *Garrity* rule, the *amicus* brief goes on to say: "But the customer agreement here does not expressly say that punitive damages are not allowed, nor does it reference the *Garrity* rule; it says only that New York law governs." (SEC Br. 27).

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potentially applicable rules of *state* law. Federal law always applies, to the extent it bears on the issues.



The question is: Why *should* the choice-of-law clause have "referenced the *Garrity* rule"? And if it should have referenced the *Garrity* rule, why not any and every other rule of New York law that one of the parties seeks to rely on? And if not every other such rule, how is a court supposed to determine which rules of law must be "expressly referenced" to be covered by a choice-of-law clause and which ones need not be? And if a court is to pick and choose what rules must be "expressly referenced," what is the point of a choice-of-law clause in the first place?

To such questions the SEC brief offers no answer. Nor does it cite any authority for the contention that *any* rule of law must be "referenced" expressly to be covered by a choice-of-law clause. The brief merely makes the bald and unsupported statement that: "Standing alone, the choice-of-law provision should not be read to incorporate state law principles that would be preempted if New York law applied of its own force. . . ." *Id.* (footnote omitted).

The brief provides no explanation or support for that pronouncement. The proposition is directly contrary to the decision in *Volt*, notwithstanding the brief's footnote asserting that "[t]his Court's decision in *Volt* is not to the contrary." *Id.* n.18. The very point of the *Volt* decision was that the choice-of-law clause incorporated state law principles that would have been preempted if California law had applied of its own force. The *amicus* brief overlooks the fact that the Court assumed in *Volt* that §§ 3 and 4 of the FAA were fully applicable to state court proceedings; without the choice-of-law agreement, the California procedural rule would clearly have been preempted. *Cf. Dean Witter Reynolds Inc. v. Byrd, supra* (forbidding stay of arbitration of arbitrable claims

which were asserted together with nonarbitrable claims).[4]

The *amicus* brief also overlooks the Court's express statement of its holding in *Volt*:

> We hold that application of the California statute is not pre-empted by the Federal Arbitration Act . . . in a case where the parties have agreed that their arbitration agreement will be governed by the law of California. (489 U.S. at 470).

Apart from all the other objections discussed above, therefore, the Government's suggested "interpretation" of the choice-of-law clause is plainly untenable in the face of the decision in *Volt*.

The holding in *Volt* is not made inapplicable, as the Government's footnote suggests, by the opinion's reference to California's rules for the conduct of arbitration as "manifestly designed to encourage resort to the arbitral process." 489 U.S. at 476. The reference was obviously not to the *particular* California statute at issue — which has the effect of preventing arbitration in the cases to which it applies — but to California's overall scheme for the conduct of arbitration. There is no doubt that New York's rules regarding the conduct of arbitration "encourage resort to the arbitral process" as fully as do those of California. The FAA was modelled on the Arbitration Act of New York, which preceded the enactment of the

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[4] Petitioners' brief reflects the same oversight. It mistakenly argues that *Volt* was decided on the assumption that §§ 3 and 4 of the FAA did not apply to state-court proceedings. Pet. Br. 52.



FAA by approximately five years. *See* S. Rep. No. 536, 68th Cong., 1st Sess. at 3 (1924) (The FAA "follows the lines of the New York arbitration law enacted in 1920. . . .").

The New York Court of Appeals "has repeatedly held that arbitration is a favored method of dispute resolution in New York . . . and New York courts interfere as little as possible with the freedom of consenting parties to submit disputes to arbitration." *Board of Educ. v. Christa Constr., Inc.*, 80 N.Y.2d 1031, 1032, 608 N.E.2d 755, 755, 593 N.Y.S.2d 178, 178 (1992) (mem.) (citations omitted), *modified on other grounds*, 80 N.Y.2d 1033, 608 N.E.2d 756, 593 N.Y.S.2d 179 (1993); *Lipschutz v. Gutwirth*, 304 N.Y. 58, 61, 106 N.E.2d 8, 10 (1952) ("The purpose of [the New York arbitration statute] is to give effect to contracts providing for the settlement of disputes before tribunals of the parties' own choosing by rendering such agreements irrevocable and, in effect, subject to specific enforcement.").

Moreover, it is hard to see how arbitration is encouraged by straining to interpret an arbitration agreement as conferring on the arbitrators power to award punitive damages. The petitioners' position would have the courts bend arbitration agreements in the direction of giving claimants the broadest possible benefits. The utility of arbitration depends on the willingness of parties to submit their disputes to the process. If the judicial approach is to put a thumb on the plaintiff's side of the scale in interpreting the agreement, resort to the process is at least as likely to be deterred as encouraged, especially when the remedy

at issue gives arbitrators an uncontrolled and unreviewable discretion to assess punitive damages.[5]

In any event, it is not evident why the *interpretation* of a choice-of-law provision should be influenced by whether a rule otherwise within the reach of the provision is one that "encourages resort to arbitration" when it is clear, as the *Volt* opinion indicates and the Government concedes, that an "express" adoption of such a rule would be controlling whether or not the rule "encourages arbitration." The opinion in *Volt* had no occasion to face that question, since it accepted the interpretation placed on the choice-of-law clause by the state court. If the normal reading of a choice-of-law clause would result in incorporation, there is no discernible reason why the choice-of-law provision itself should not be the equivalent of an "express" incorporation. *See Baravati*, 28 F.3d at 709 (7th Cir. 1994) (commenting on the cases involving incorporation of the American Arbitration Association rules: "These courts, however, would enforce a provision in an arbitration clause that *forbade* the arbitrator to award punitive damages; and if, as we thought was the situation in *Mastrobuono*, the parties do the same thing by invoking a body of law that contains such a prohibition, there would be

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[5] It is paradoxical that the Government, in sharp contrast to the great deference it urges on the question whether the arbitrators have *power* to award punitive damages (SEC Br. 12-28), is at pains to suggest that § 10(a)(4) of the FAA nevertheless permits judicial review of the *amount* of a punitive damages award. SEC Br. 20 n. 14. The two positions are not easily reconciled. Nor are we aware of any decision where a court, pursuant to § 10(a)(4), has reduced the amount of an arbitral award of punitive damages on the basis that it was excessive.



no greater reason to refuse to honor their choice." (emphasis in original)).

Neither petitioners nor the *amicus* suggests any general principle of contract interpretation that could lead to the conclusion that a choice-of-law clause adopting New York law does not, standing alone, incorporate the *Garrity* rule. (Whether the choice-of-law provision is *contradicted* by other provisions in the agreement is a separate question, which we deal with in detail below. *See* 28-34, *infra*).

In the absence of any limiting provisions, it is fundamental that a choice-of-law clause incorporates not only the liability law of the chosen state, but its law relating to remedies, including whether punitive damages are available. *See, e.g., Moses v. Business Card Express, Inc.*, 929 F.2d 1131, 1139 (6th Cir.), *cert. denied*, ___ U.S. ___, 112 S. Ct. 81 (1991) (choice-of-law clause required application of Michigan rule denying punitive damages notwithstanding parties' relationship to Alabama, whose law permitted such damages); *Power Motive Corp. v. Mannesmann Demag Corp.*, 617 F. Supp. 1048, 1049-50 (D. Colo. 1985) (choice-of-law clause required application of Ohio rule denying punitive damages in contract actions although the law of Colorado, the forum state, would permit such damages); *Kammerer v. Western Gear Corp.*, 96 Wash. 2d 416, 421-23, 635 P.2d 708, 711-12 (1981) (choice-of-law clause adopting California law entitled plaintiff to award of punitive damages although law of Washington, the forum state, would not).

There is no reason to interpret a choice-of-law clause as having a narrower scope than the choice of law that would be dictated by conflict-of-laws principles. Under accepted principles of conflict of laws, the chosen state's law determines the available

remedies. Thus, § 171 of the Restatement provides with respect to torts that damages are to be determined according to the law of the state chosen under the rule of § 145, which is the rule prescribing the law applicable to "the rights and liabilities of the parties." Restatement §§ 145(1), 171 (1971). Similarly, § 207 provides with respect to contracts that the measure of recovery is to be determined by the law of the state that determines the "rights and duties of the parties," *i.e.*, either under Section 188 (which specifies the law applicable in the absence of an effective choice by the parties) or under Section 187 (which is the "law of the state chosen by the parties to govern their contractual rights and duties"). *See, e.g.*, *Rice v. Nova Biomedical Corp.*, 1994 WL 580905 at *7-8 (7th Cir. Oct. 25, 1994) (choosing the law of Illinois, which permits punitive damages, rather than the law of Massachusetts, which does not); *Computer Systems Engineering, Inc. v. Qantel Corp.*, 571 F. Supp. 1365, 1368-70 (D. Mass. 1983), *aff'd*, 740 F.2d 59 (1st Cir. 1984) (choosing the law of Massachusetts rather than the law of California, which permits punitive damages); *Barr v. Interbay Citizens Bank*, 96 Wash. 2d 692, 700, 635 P.2d 441, 445 (1981), *modified on other grounds*, 96 Wash. 2d 692, 649 P.2d 827 (1981).

In short, there is no basis either in logic or in recognized conflict-of-laws principles for grafting onto a choice-of-law clause a distinction between "substance" and "remedy." Remedy *is* substance. Whether the choice-of-law clause is contradicted or limited by some other clause is a different question, as we have already noted. The opinion in *Baravati*, *supra*, explains the decisions of other circuits as reflecting the belief that choice-of-law provisions and provisions incorporating particular arbitration rules



are best "*reconciled*" by confining the choice-of-law provision to substantive matters, allowing arbitrators "free rein in procedural and remedial matters." 28 F.3d at 709 (emphasis added). In the present case, however, as we will show, there is nothing to "reconcile" with the choice-of-law clause and that clause must therefore be given its ordinary effect.

The rule in *Garrity* has been held to be a substantive rule of New York law by federal judges sitting in New York. *See Barbier*, 948 F.2d at 122 (2d Cir. 1991). Those views are entitled to special weight as to what the New York law requires. *Bernhardt v. Polygraphic Co.*, 350 U.S. 198, 204-05 (1956), and cases cited. *Cf. Hunt v. Bankers & Shippers Ins. Co.*, 73 A.D.2d 797, 798, 423 N.Y.S.2d 718, 720-21 (4th Dep't 1979) (measure of prejudgment interest is substantive under New York state law), *aff'd*, 50 N.Y.2d 938, 409 N.E.2d 928, 431 N.Y.S.2d 454 (1980). State law is controlling as to the interpretation of the choice-of-law clause. *Volt*, *supra*, 489 U.S. at 474 ("Appellant acknowledges, as it must, that the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review."). The relevant state's law is that of New York, because the choice-of-law clause says so.

The petitioners agree with the characterization of the *Garrity* rule as substantive; indeed, they say it is "clearly" substantive. Pet. Br. 56. Inexplicably, they regard the "substantive" nature of the rule as a ground for distinguishing this case from *Volt*. *Id.* The reverse is true: Characterizing the rule as "substantive rather than procedural" makes this an *a fortiori* case for applying *Volt*, because it eliminates any possible ground for treating the rule as outside the scope of the choice-of-law provision. What

petitioners really mean is that *Volt* is wrong; they believe that parties should not be allowed to limit an arbitrator's powers, a position contrary to everything this Court has ever said about the FAA.

### B. The Choice-Of-Law Clause Is Entirely Consistent With The NASD Arbitration Rules.

The agreement in this case provides that any controversy arising out of or relating to the customer's accounts or transactions

> shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I [the customer] may elect. If I do not make such election . . . within five days after demand by you that I make such election, then you may make such election.

(R. 59, Ex. A, ¶ 13).

The arbitration in this case was conducted in accordance with the rules of the NASD upon respondents' election after petitioners failed to exercise their right to make an election.[6] The arbitration rules

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[6] It has not been contended by petitioners that the rules of the New York or American Stock Exchanges contain any authority for awarding punitive damages, even if one of those sets



of the NASD are contained in the Code of Arbitration Procedure adopted pursuant to Article VII, Section 1(a)(3) of the Bylaws of the National Association of Securities Dealers. *See* NASD Manual, Code of Arbitration Procedure, Part I, § 1 (CCH) ¶3,701 (1994). The Code has been approved by the SEC as required pursuant to § 19(b)(1) of the Securities Exchange Act. *See* 15 U.S.C. § 78s(b)(1).

The NASD Code of Arbitration Procedure consists of forty-four sections, most of which deal with purely procedural matters. There is no mention of punitive damages. There are only two sections that might be read as bearing on the scope of the arbitrators' powers and neither contains any language that purports to give them any remedial authority not found in the agreement of the parties.

Section 12(a) provides as follows:

> Any dispute, claim, or controversy eligible for submission under Part I of this Code between a customer and a member . . . shall be arbitrated under this Code, *as provided by any duly executed and enforceable written agreement* or upon the demand of the customer. (Emphasis added).[7]

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of rules had been elected.

[7] Contrary to the arguments raised by amicus curiae (AALP Br. 13-15), the petitioners in this instance did not demand arbitration pursuant to Section 12(a). Rather, they steadfastly opposed arbitration and were compelled to such arbitration under a "duly executed and enforceable written agreement."

Far from providing any authority beyond what the arbitration agreement allows, this Section reinforces the limitations of the agreement: it specifies that the agreement governs the arbitration.

Section 41 of the Code deals with awards. Section 41(e) provides as follows:

> The award shall contain the names of the parties, the name of counsel, if any, a summary of the issues, including the type(s) of any security or product in controversy, the damages and other relief requested, the damages and other relief awarded, a statement of any other issues resolved, the names of the arbitrators, the dates the claim was filed and the award rendered, the number and dates of hearing sessions, the location of the hearings, and the signatures of the arbitrators concurring in the award.

There is no language in this Section that could plausibly be read as conferring any remedial powers, and certainly not any powers that are otherwise prohibited by the arbitration agreement.

The district court and the court of appeals were therefore correct in concluding that the incorporation of the NASD rules of procedure did not contradict or limit the arbitration agreement's adoption of New York law. A different panel of the Seventh Circuit has subsequently reached the same conclusion concerning the NASD rules of arbitration procedure. In *Baravati, supra*, the court held that the NASD rules are "silent" on the subject of the arbitrators' powers:



> NASD's Code of Arbitration Procedure, incorporated by reference in the contract between Baravati and JLR, requires arbitrators to provide "a summary of . . . the damages and other relief awarded," but contains no other reference to the arbitrators' remedial powers. (28 F.3d at 709).

Then, after referring to this case (*Mastrobuono*) and other cases dealing with the *Garrity* issue under choice-of-law provisions, the court continued:

> This disagreement does not bear directly on the present case, however, where there is *neither* a choice of law provision *nor a provision in the governing arbitration rules* concerning the scope of the arbitrators' remedial powers. *Id.* (emphasis added).

The same conclusion regarding the meaning of the NASD rules was reached by the California Court of Appeal in *J. Alexander Securities, Inc. v. Mendez*, 17 Cal. App. 4th 1083, 21 Cal. Rptr. 2d 826 (Ct. App. 1993), *cert. denied*, ___ U.S. ___, 114 S. Ct. 2182 (1994), the only other case to consider the effect of the NASD Code of Arbitration Procedure on an arbitration agreement like the one in this case. The court agreed that the NASD Code (as well as the NYSE Rules) was "silent" on the issue of punitive damages. 17 Cal. App.

4th at 1092, 21 Cal. Rptr. 2d at 831. No case appears to have taken a different view of the NASD Code.[8]

Since nothing in the NASD Code of Arbitration Procedure contradicts or impairs the necessary meaning of the choice-of-law clause in the arbitration agreement in this case, there is no basis for finding any ambiguity in the agreement or for resorting to a presumption in favor of a broad interpretation of the arbitrators' powers with respect to punitive damages.[9]

With the single exception of *J. Alexander Securities, Inc. v. Mendez*, discussed *supra*, every one of the cases cited by petitioners as refusing effect to a

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[8] The California court nevertheless refused to give effect to the choice-of-law clause as incorporating the *Garrity* rule, relying at least in part on what it referred to as "the prevailing policy in California." For the reasons set forth in this brief, respondents submit that the decision was erroneous. The court did not discuss *Volt*.

[9] The opinion below also referred to language in the Manual provided to NASD arbitrators stating that "arbitrators can consider punitive damages as a remedy." The court said that it did not think the Manual "authorizes an award of punitive damages in derogation of the governing law of the agreement." 20 F.3d at 717. It is not clear what the court meant, but its conclusion was clearly correct because the arbitrators' Manual is not incorporated in the arbitration agreement. The Manual is not part of the rules of procedure of the NASD and is not even promulgated by the NASD. It is not a set of rules, but merely a compilation of general information for the benefit of arbitrators, compiled by members of SICA (Securities Industry Conference on Arbitration). Many arbitrations before the NASD do not involve agreements that contain choice-of-law provisions. (Among other things, the arbitrators' Manual emphasizes that when an arbitrator's authority is derived from an agreement of the parties, the arbitrator should not exceed that authority.) SICA, The Arbitrator's Manual, at 38 (Cannon I.F.) (May 1992).



choice-of-law provision like the one in this case involved an arbitration agreement that incorporated the American Arbitration Association's Commercial Arbitration Rules ("AAA Rules"). In each of the cases, the decision relied on the existence of AAA Rule 43 as overriding or at least creating a contradiction with the choice-of-law clause.[10] *See Lee v. Chica*, 983 F.2d 883, 887-88 (8th Cir.), *cert. denied*, ___ U.S. ___, 114 S. Ct. 287 (1993); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062-63 & n.6 (9th Cir. 1991); *Raytheon Co. v. Automated Bus. Sys., Inc.*, 882 F.2d 6, 11-12 n.5 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988); *Willoughby Roofing & Supply v. Kajima Int'l, Inc.*, 598 F. Supp. 353, 358 & n.11 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985) (per curiam).

The courts relying on AAA Rule 43 focus on the language "any remedy or relief that the arbitrator deems just and equitable" but fail to give effect to the qualifying language, "within the scope of the agreement of the parties. . . ." *See* Tjoflat, J., concurring on other grounds but disagreeing as to the

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[10] In contrast to the NASD Code of Arbitration Procedure, the AAA Rules contain a provision addressing the scope of the arbitrator's remedial powers. The provision is as follows:

> 43. Scope of Award.
>
> The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties, including, but not limited to, specific performance of a contract.

meaning of AAA Rule 43, *Bonar*, 835 F.2d at 1388-89. Thus, to the extent that the parties have agreed to limit the powers of the arbitrators through a choice-of-law clause, a court should enforce that limitation.[11]

Even if correct on their own facts, however, the conclusions in those cases cannot be applied to this case. Assuming the terms of Rule 43 coupled with a choice-of-law clause provide at least a colorable basis for viewing the arbitration agreement as ambiguous, a presumption in favor of finding power in the arbitrators to award "any remedy or relief" might be appropriate. The same cannot be said in this case, for there is no clause in the NASD rules that defines the powers of the arbitrators and therefore nothing in the arbitration agreement to contradict the necessary meaning of the choice-of-law clause.

## III. THE PUNITIVE DAMAGES AWARD EXCEEDED THE ARBITRATORS' POWERS AND WAS THEREFORE PROPERLY VACATED UNDER SECTION 10 OF THE FEDERAL ARBITRATION ACT.

The *amicus* brief of the Government argues that the courts below failed to give proper deference to the arbitrators' construction of the contract and therefore could not properly have concluded that the award "exceeded [the arbitrators'] powers" within the

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[11] *Raytheon* is further distinguishable: (1) The law of California (the state law chosen by the choice-of-law provision) was unclear as to the availability of punitive damages in arbitration, *see* 882 F.2d at 11-12, and (2) the parties stipulated that federal, not state, law applied. *Id.* at 11-12 n.5.



meaning of § 10(a)(4) of the FAA. SEC Br., Point II, 12-28.

That ground for reversal was raised by petitioners in the court of appeals and rejected by that court. 20 F.3d at 716. In this Court, however, the ground has been abandoned by petitioners. It is asserted neither in the Petition for Certiorari nor in petitioners' brief on the merits. *See* Questions Presented, Pet. i, Pet. Br i. We respectfully suggest, therefore, that the issue of the scope of review of the arbitral award is not properly before the Court. *See Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 25 n.2 (1991).

In any event, the argument urged by the *amicus* is not applicable to the facts of this case. The argument assumes that the arbitrators' decision that they had power to award punitive damages was reached by "interpreting the contract." *See* SEC Br. Point II, *passim*. The fact is, however, the arbitrators did not "interpret the contract" for this purpose but instead found it unnecessary to consider the contract's language.

The arbitral award stated:

> Respondents . . . shall pay to Claimants . . . the sum of $400,000.00 in punitive damages. The authority for the Award of punitive damages can be found in Claimants' Response to Shearson's Brief in Opposition to Punitive Damages that had been filed with the NASD on October 6, 1992.

(R. 59, Ex. D, at 4).

Petitioners, in the submission the arbitrators purported to rely upon for the punitive damages award, argued, *inter alia*, that the arbitrators were not required to follow either the "letter of the law" or the "letter of . . . the agreement":

> This panel can and should do justice for the parties and apply the rules of law and equity as the arbitrators see them. *The panel's decision should reflect the spirit rather than the letter* of the law and *of the parties' agreement*.

(R. 59, Ex. C, at 2 (emphasis added)).

Thus, there is no basis in this case for saying or presuming that the arbitrators "interpreted the contract" with respect to the extent of their powers. The arbitrators themselves have revealed that the contrary is true.

The Government's argument rests on the premise that the arbitrators' construction of the agreement is "reasonable" (SEC Br. 19, 25) and reflects an "accommodation" of "ambiguities" in the agreement. *Id.* at 22-25. For the reasons already set forth, there are no inconsistencies or ambiguities in the arbitration agreement here that would support ignoring the *Garrity* rule. Any purported interpretation of the agreement that did so would not have been within the bounds of a fair construction of the agreement. Even accepting the Government's deferential standard of review, therefore, the court would have owed *no* deference to such an interpretation. Thus, this case does not require the Court to "address in detail standards governing the



application of" the requirement of § 10(a)(4) of the FAA that a court vacate an award "[w]here the arbitrators exceeded their powers. . . ." SEC Br. 14.

As the Government's brief indicates, prior decisions of this Court have not had occasion to address § 10(a)(4). SEC Br. 14. Section 10 clearly delineates the specific grounds upon which courts may act to vacate an arbitration award. Congress in § 10(a)(4) expressly provided for judicial vacation of arbitration awards where the arbitrators "exceeded their powers." Thus, the Government's general arguments with respect to the limited number of statutory-mandated bases for vacation of arbitration awards cannot overlook the express grant of judicial authority in § 10(a)(4) to vacate awards where the arbitrators "exceeded their powers." Moreover, there is no suggestion in § 10(a)(4) that a court defer to the arbitrators' own determination of whether they have "exceeded their powers."

What is clear is that § 10(a)(4) requires courts to distinguish between arbitrators' awards that merely "interpret the agreement" and ones that "exceeded their powers," and to exercise their own judgment over whether an award violates the latter limitation. To be sure, every question relating to the powers of an arbitrator is ultimately a question of construction of the arbitration agreement. But the converse is not true: Not every question of construction of the agreement is a question of the arbitrator's "powers." If it were, § 10(a)(4) would have no meaning; it would give courts no more authority when arbitrators "exceeded their powers" than when they act within their powers. The Government's arguments would obliterate the distinction and render § 10(a)(4) meaningless.

For arbitrators to award punitive damages when an arbitration agreement forbids them to do so would seem to be a paradigm of the category to which § 10(a)(4) applies. As the court below said (quoting *Barbier*, 948 F.2d at 122) "[t]here is no clearer case of a case falling . . . within § 10(a)(4)" of the FAA. 20 F.3d at 716. The court below and the Second Circuit are not alone in assuming that the court must decide for itself whether arbitrators have "exceeded their powers" by awarding punitive damages. Regardless of result, the same view appears to have been held by all the other courts of appeals that have considered the question presented by this case, *i.e.*, whether there was power to award punitive damages under an arbitration agreement containing a choice-of-law clause. In none of those cases did the court resolve the question by deferring to the arbitrators' views. *See* cases cited *supra*, 32-33. *See also Humphrey v. Moore*, 375 U.S. 335, 345 n.8 (1964) ("Reconciliation of these two provisions [of the agreement], going to the power of the committee under the contract, itself presented a issue ultimately for the court, not the committee, to decide."); *Cargill Rice, Inc. v. Empresa Nicaraguense Dealimentos Basicos'*, 25 F.3d 223, 226 (4th Cir. 1994) ("[E]ven if the arbitrators here could somehow have interpreted the contract to determine how they should be selected . . . their interpretation would not be entitled to deference because it would have involved a determination of their own jurisdiction." (citations omitted)). To the same effect is the Seventh Circuit's recent decision in *Baravati*, *supra*.

The *Baravati* opinion in particular is illuminating as to the scope of review required by § 10(a)(4). The opinion carefully examined the scope of review of arbitral decisions and adopted a highly



deferential view, rejecting even the "manifest disregard" standard. *See* 28 F.3d at 706. Having done so, the court said: "So it will be enough in this case to consider whether the arbitrators exceeded their powers." *Id*. Then, addressing the question whether the arbitrators had power to award punitive damages, the court interpreted the agreement for itself and did not defer to some supposed interpretation of the contract by the arbitrators.

The Government purports to find some support for its view that the court must defer to the arbitrators' interpretation of their own powers in this Court's decision in *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593 (1960), a labor case that did not refer to or purport to interpret § 10 of the FAA. Any analogy between that case and this one is only superficial. In fact, the case illustrates the distinction between "exceeded [the arbitrators'] powers" and other kinds of contract interpretation.

Whether an arbitrator has any power to grant specific performance, or to order reinstatement of employees, or to award punitive damages is different from the question whether such relief may be awarded under the facts of the particular case. The question in *Enterprise Wheel* was of the latter kind. There was no doubt of the arbitrator's authority in general to award reinstatement and back pay; the only question was whether the contract permitted the back pay to extend beyond the date when the employer theoretically could have discharged the employee as an employee at will. That was a question more aptly called a question of interpretation of the labor contract than a question of

the "powers" of the arbitrator.[12] If § 10(a)(4) of the FAA means anything, it must refer at least to questions of the generic kind, *i.e.*, whether under the agreement the arbitrators have power to award the particular category of relief at all. As to such questions § 10(a)(4) of the FAA can only mean that a court is to decide the issue, just as it must do when the question is whether an issue is subject to arbitration.

This Court has made clear that questions whether the parties have agreed to arbitrate and, if so, what issues are included within that agreement, are for the court to decide, not the arbitrator. *See AT & T Technologies, Inc. v. Communications Workers of America*, 475 U.S. 643, 649 (1986) ("[T]he question of arbitrability . . . is undeniably an issue for judicial determination. Unless the parties *clearly and unmistakably provide otherwise*, the question of whether the parties agreed to arbitrate is to be decided by the court, not the arbitrator." (emphasis added)); *John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543, 546-47 (1964) ("[N]o doubt" that "[u]nder our decisions, whether or not the company was bound to arbitrate, as well as what issues it must arbitrate is a matter to be determined by the Court on the basis of the contract entered into by the parties."); *Atkinson v.*

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[12] The same is true of the issue dealt with in *W.R. Grace & Co. v. Local Union 759*, 461 U.S. 757 (1983), quoted in a footnote in the Government's brief at page 17. The question in that case was whether a subsequent arbitrator was bound by a prior arbitrator's construction of the collective bargaining agreement. It was not a question whether the arbitrators possessed a particular type of power, but only whether their exercise of their powers was consistent with the collective bargaining agreement.



*Sinclair Refining Co.*, 370 U.S. 238, 241 (1962) (determination of "what issues [a party] must arbitrate is a matter to be determined by the Court on the basis of the contract entered into by the parties."); *United Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 583 n.7 (1960) (The "question of arbitrability is for the courts to decide. Where the assertion . . . is that the parties excluded from court determination not merely the decision of the merits of the grievance but also the question of its arbitrability, vesting power to make both decisions in the arbitrator, the claimant must bear the burden of a clear demonstration of that purpose." (citation omitted)).

This Court also has stated with regard to labor arbitrations that: "The willingness of parties to enter into agreements that provide for arbitration of specified disputes would be 'drastically reduced,' however, if a labor arbitrator had the 'power to determine his own jurisdiction. . . .'" *AT & T Technologies, Inc.*, 475 U.S. at 651 (quoting Cox, Reflections Upon Labor Arbitration, 72 Harv. L. Rev. 1482, 1509 (1959)). That principle also is applicable to commercial arbitrations.

The Government's brief concedes, as we have previously discussed, that the parties could have "expressly" agreed that the choice-of-law clause included New York's *Garrity* rule. In such a case could the Government plausibly urge that it was within the power of the arbitrators to "interpret the agreement" and, therefore, a court could not vacate the award? The answer must surely be "No." Yet, as we have shown, the choice-of-law clause must be treated exactly as if it did "expressly" incorporate the *Garrity* rule, and nothing in the agreement is to the contrary.

If a court would ever be required to vacate such an award, it is required to do so in this case.

## IV. THE AGREEMENT BETWEEN THE PARTIES ESTABLISHES THEIR RIGHTS AND BARS PETITIONERS FROM SEEKING PUNITIVE DAMAGES IN A SEPARATE COURT PROCEEDING.

Petitioners argue that the arbitration agreement, if construed as excluding punitive damages, improperly required petitioners to "waive" their "right" to punitive damages. Pet. Br. 58-69. In other words, petitioners argue the agreement is invalid and unenforceable if it precludes punitive damages.

The argument is without merit. A similar argument was made and was rejected by the Court in *Volt*, 489 U.S. at 474-75. There the plaintiff's argument was that the court's construction of the choice-of-law clause was in effect a finding that the plaintiff had "waived" its federal right to compel arbitration. This Court said it was not a finding of "waiver" at all but a finding that the plaintiff had no such "right" in the first place, because the agreement did not require arbitration to proceed under the circumstances of the case. The same is true here. There is no waiver of any "right" because petitioners' rights are defined by the agreement, unless the agreement is invalid or is overridden by some affirmative requirement of law.

Petitioners' argument is even weaker than the one made in *Volt* because there the plaintiff had at least a colorable basis for arguing that its alleged "right" was conferred by the FAA. But here



petitioners cannot credibly claim that the FAA or any other federal statute or policy gives them a right to punitive damages. There is not the slightest basis for saying that the FAA favors punitive damages. Nor is there any other federal statute applicable in this case that could be the source of such a right; the fact is that all of the express and implied private rights of action under the Securities Act and the Exchange Act -- the principal bodies of federal law which govern the securities markets -- preclude the award of punitive damages. 15 U.S.C. §§ 77l, 78bb(a). *See, e.g., Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1283-87 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Thus, Congress has never deemed it necessary for "investor protection" to confer upon investors any "right" to seek punitive damages under applicable federal law.[13]

If the alleged "right" to punitive damages is not conferred by federal law, what is its supposed source?[14] Petitioners do not say. They obviously do not mean New York law, because New York law under the circumstances of this case provides that there is *no* right to punitive damages. If the right is supposedly

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[13] Although investors may not seek punitive damages under the federal securities laws, the securities industry is governed by a myriad of federal and state agencies, and self-regulatory organizations, including but not limited to the SEC, the Securities Divisions of all fifty states, the New York Stock Exchange, the American Stock Exchange, and the NASD, all of which have the power to fine, suspend, and expel brokerage firms and their employees.

[14] State law is the only logical choice because there are no federal claims that allow for the recovery of punitive damages in this case.

conferred by some other state, what state — any state whose law happens to favor the petitioners' position?

Petitioners are in effect attacking choice-of-law clauses. They claim that respondents caused them to sign an agreement with a choice-of-law clause that, with respect to a particular issue, has turned out to be unfavorable to them. The argument is unrelated to the fact that the *Garrity* rule applies to arbitrators, not courts. If the choice-of-law clause adopted the law of, say, Washington or Nebraska, states that do not allow punitive damages at all, petitioners' argument would be the same. Their position is that a choice-of-law clause cannot be used to effect a "waiver" of any arguably applicable rule that happens to favor the plaintiffs. Their brief is explicit on the point:

> The usefulness of this "waiver by implication" precedent does not end with just punitive damages. One can hypothecate [sic] any number of similar issues which choice-of-law provisions may obviate, depending on the state of choice, thereby increasing the prejudice to investors and the degree to which the deck can be stacked against them. (Pet. Br. 66-67).

The Court could not accept petitioners' "waiver" argument without completely undermining the utility of choice-of-law clauses in contracts covered by the Federal Arbitration Act. Choice-of-law clauses obviously have "salutary effects" of the same general nature as those referred to by the Court in upholding the forum-selection clause involved in *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 593-94 (1991). In



that case the Court said: "[W]e do not adopt the Court of Appeals' determination that a nonnegotiated forum-selection clause in a form ticket contract is never enforceable simply because it is not the subject of bargaining." *Id.* at 593. The Court has also recently said:

> Mere inequality in bargaining power, however, is not a sufficient reason to hold that arbitration agreements are never enforceable in the employment context. Relationships between securities dealers and investors, for example, may involve unequal bargaining power, but we nevertheless held in *Rodriguez de Quijas* and *McMahon* that agreements to arbitrate in that context are enforceable.

*Gilmer*, 500 U.S. at 33 (citations omitted).

Petitioners' argument is essentially that the Court should decline to enforce the arbitration agreement, or the choice-of-law clause it contains, on grounds of unconscionability. Other objections to the argument to one side, the contention is one that was not made or considered below and there is no factual record to support it. That in itself is a sufficient ground for rejecting it. *See, e.g., DeShaney v. Winnebago County DSS*, 489 U.S. 189, 195 n. 2 (1989); *Duignan v. United States*, 274 U.S. 195, 200 (1927).[15]

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[15] Petitioners would have the Court believe that investors are helpless and have no choice but to accept an arbitration agreement of the kind involved in this case. The facts are otherwise. The SEC has specifically considered that question and

Finally, the lower courts properly denied petitioners' alternative request to separately seek punitive damages in court. As both lower courts properly found, under the plain language of the agreement petitioners were entitled only to the relief available in arbitration under New York law. 20 F.3d at 718; 812 F. Supp. at 848. Moreover, as the district court found, neither Illinois nor New York law permits a separate cause of action for punitive damages. 812 F. Supp. at 848. *See also Kemner v. Monsanto Co.*, 217 Ill. App. 3d 188, 199, 576 N.E.2d 1146, 1153, 160 Ill. Dec. 192, 199 (5th Dist.), *app. denied*, 142 Ill. 2d 655, 584 N.E.2d 130, 164 Ill. Dec. 918 (1991); *McGrew v. Heinold Commodities, Inc.*, 147 Ill. App. 3d 104, 110, 497 N.E.2d 424, 429, 100 Ill. Dec. 446, 451 (1st Dist. 1986); *Florsheim v. Travelers Indem. Co.*, 75 Ill. App. 3d 298, 309-10, 393 N.E.2d 1223, 1233, 30 Ill. Dec. 876, 886 (1st Dist. 1979); *Bishop v. Bostick*, 141 A.D.2d 487, 489, 529 N.Y.S.2d 116, 118 (2d Dep't 1988); *Santos v. Security & Law Enforcement Employees, Council 82*, 80 A.D.2d 554, 554, 435 N.Y.S.2d 357, 358 (2d Dep't 1981).

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concluded as follows: "[T]he Commission is reluctant to dictate the terms of a fully disclosed agreement between a broker-dealer and a customer. Investors currently have access to basic brokerage services without agreeing to pursue any future disputes through arbitration, rather than through the courts. This is so because a number of broker-dealers, including several large full-service broker-dealers in the country, do not require the signing of account agreements for cash accounts." Order Approving Proposed Rule Changes by the NYSE, NASD and the AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, SEC Rel. No. 34-26805, 54 Fed. Reg. 21,144, 21,154 (1989) (footnote omitted).



## CONCLUSION

For all the foregoing reasons, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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9 U.S.C. § 3 provides:

**Stay of proceedings where issue therein referable to arbitration.**

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

9 U.S.C. § 4 provides, in relevant part:

**Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination.**

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. . . .



9 U.S.C. § 10(a)(4) provides:

**Same; vacation; grounds; rehearing.**

(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration --

* * *

(4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

Supreme Court, U.S.
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DEC 29 1994
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No. 94-18

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1994

**Antonio C. Mastrobuono and Diana G. Mastrobuono,**

*Petitioners,*

v.

**Shearson Lehman Hutton Inc., a corporation, and Nick DiMinico,**

*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## REPLY BRIEF FOR PETITIONERS

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## REPLY BRIEF OF PETITIONERS

### I.

### THE PRINCIPLE THAT THE FAA REQUIRES ENFORCEMENT OF ARBITRATION AGREEMENTS AS WRITTEN REQUIRES ENFORCEMENT OF THE PARTIES' COMPREHENSIVE AGREEMENT TO ARBITRATE, AND PREEMPTS NEW YORK STATE LAW WITHDRAWING THE PARTIES' ABILITY TO AGREE TO ARBITRATE ALL ISSUES, INCLUDING PUNITIVE DAMAGES.

(Reply to Resp. Br., Pt. I, pp. 12-16).

Respondents assert that the FAA requires enforcement of arbitration agreements according to their terms but neither creates new rights nor compels arbitration. (Resp. Br., pp. 12-13). Petitioners do not dispute this principle but respectfully submit that respondents' attempt to apply that principle to the facts presented here rests on a flawed analysis. Respondents' argument narrowly focuses on the New York choice-of-law

provision contained in the Client's Agreement and completely disregards the comprehensive arbitration provision, by which the parties agreed to arbitrate "any controversy arising out of or relating to [the Mastrobuonos'] accounts, to transactions with you, your officers, directors, agents and/or employees for [the Mastrobuonos] or to this agreement or the breach thereof...." That the Client's Agreement also contains a New York choice-of-law provision and, under New York state law, arbitrators cannot award punitive damages, does not detract from the enforceability, as a matter of federal substantive law, of an arbitration clause governed by the FAA, because, as respondents acknowledge, the FAA requires enforcement of arbitration agreements. The arbitration agreement involved here is



extremely broad and does not purport to withhold any matter relating to the Client's Agreement from arbitral consideration or to limit the remedies which the arbitrator may award.

Moreover, respondents argue, "Since the FAA requires enforcement of the designation of New York law in the parties' agreement, the FAA mandates enforcement, not preemption, of the New York rule of [*Garrity*] in this case." (Resp. Br., p. 14). Respondents are incorrect. As discussed at length in petitioners' opening brief, the New York restriction on arbitral authority is in fundamental conflict with the goals of the FAA and embodies the misguided over-protection of judicial jurisdiction which the FAA was enacted to overcome. As this Court has made clear again and again,

state law hostile to arbitration is preempted by the FAA. (See Pet. Br., pp. 18-30). Contrary to respondents' assertions, preemption is equally applicable here, where the law of a state named in a choice-of-law provision is asserted to obviate the enforceability of arbitration agreements by withdrawing arbitral power, arguably by implication, to resurrect anti-arbitration state law and to accomplish indirectly what this Court has indicated may not be done directly.

Respondents' argument is also fatally flawed because it is based on circuitous reasoning which achieves an untenable result. Respondents contend that the parties agreed to a New York choice-of-law provision, thereby incorporating the *Garrity* rule into their agreement, and



that the FAA requires enforcement of the agreement and, therefore, enforcement of the *Garrity* rule. This argument is, however, based on a misapprehension of the content of the New York law which governs by virtue of the choice-of-law clause. Because the agreement here involves interstate commerce, it is ultimately governed by federal law, the FAA. A state choice-of-law clause does not impact or "preempt" the application of federal law. As respondents acknowledge, federal law always applies. (Resp. Br., pp. 19-20, n. 3).

For example, it is undisputed that if New York state law applied to the agreement as a matter of application of conflict-of-law principles, the FAA would preempt application of the New York rule against arbitral awards of punitive

damages. Contrary to respondents' assertions (Resp. Br., p. 21), discussed further *infra*, there is no basis for reaching a different result where New York law applies by virtue of a choice-of-law provision contained in the parties' agreement; the New York law which applies by reason of a choice-of-law clause is the state law not preempted by federal law. To conclude otherwise would render the FAA a nullity and would yield a result wholly contrary to Congress' intent in enacting the FAA by allowing it to be used as a tool to *enforce* rather than overcome state law which expressly withdraws the ability of the parties to agree to arbitral awards of punitive damages and which reserves the right to award punitive damages exclusively to the judicial forum.



## II.

## THE PARTIES' COMPREHENSIVE AGREEMENT TO ARBITRATE DOES NOT WITHDRAW FROM THE ARBITRATORS THE POWER TO AWARD PUNITIVE DAMAGES.

(Reply to Resp. Br., Pts. IIA and IIB, pp. 17-34).

### A. The New York Choice-Of-Law Clause Contained In The Parties' Agreement Does Not Include The *Garrity* Rule; With Respect To Arbitration Agreements Involving Interstate Commerce, The FAA Preempts The *Garrity* Rule.

Respondents argue, "Nothing in the FAA or in any of this Court's decisions under the Act suggests that there is any federal policy that is hostile to choice-of-law clauses or justifies selectively excising legal rules that would normally be within the ambit of a choice-of-law clause." (Resp. Br., p. 17). Petitioners, however, have not suggested that choice-of-law clauses are not enforceable, but that they should be

applied in the manner in which they are typically intended to function. As respondents acknowledge, the function of a choice-of-law provision is to designate the state law that will apply, rather than leave the determination of what state law will apply to the application by the courts (or arbitrators) of conflict-of-law principles. (See Resp. Br., pp. 19-20, n. 3). For this reason, the cases cited by respondents in support of their assertion that, "[i]n the absence of any limiting provisions, it is fundamental that a choice-of-law clause incorporates not only the liability law of the chosen state, but its law relating to remedies, including whether punitive damages are available," are distinguishable. (Resp. Br., p. 25). All of the cases cited involve enforcement of the law of the state named in a choice-



of-law provision rather than the law of *another state*. None of the cases cited addresses the impact of the FAA. Petitioners do not contest that a state may generally limit or preclude the availability of certain remedies. The FAA, however, precludes states from limiting the availability of remedies based on the fact that they are to be determined, pursuant to an arbitration agreement, in an arbitral forum. See *Perry v. Thomas,* 482 U.S. 483, 492, 107 S.Ct. 2520, 96 L.Ed.2d 426 (1987).

Respondents acknowledge, as they must, that a state choice-of-law clause does not impact upon the application of federal law but ignore the import of this acknowledgment. Here, irrespective of the New York choice-of-law provision contained in the parties' agreement, federal law

applies, federal law which establishes "a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary." See *Moses H. Cone Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983).

Nonetheless, respondents assert that federal law does not have any preemptive impact upon state law incorporated into an agreement by virtue of a choice-of-law clause. In support of their argument, respondents cite this Court's decision in *Volt Info. Sciences, Inc. v. Board of Trustees,* 489 U.S. 468, 109 S.Ct. 1248, 103 L.Ed.2d 488 (1989), claiming, "The very point of the *Volt* decision was that the choice-of-law clause incorporated state law principles that would have been



preempted if California law had applied of its own force." (Resp. Br., p. 21). This is simply incorrect. This Court's decision in *Volt* is discussed at length in petitioners' opening brief. (Pet. Br., pp. 44-53). However, it should be emphasized here that at issue in *Volt* were state procedural arbitration rules which the Court determined were "manifestly designed to encourage resort to the arbitral process," not a blanket state law restriction on arbitral authority, like that at issue here.[1] The Court further

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[1] For this reason, whether New York state law encompasses procedural arbitration rules which may or may not encourage resort to the arbitral process is simply irrelevant. (See Resp. Br., pp. 22-23).

Respondents also contend that, "Characterizing the [*Garrity*] rule as 'substantive rather than procedural' makes this an *a fortiori* case for applying *Volt*, because it eliminates any possible ground for treating the rule as outside of the scope of the choice-of-law provision."

concluded that the California arbitration rules did not offend any policy embodied in the FAA and that the parties' agreement to abide by state rules of arbitration could be enforced "without doing violence to the policies behind the FAA." *Volt*, 489 U.S. at 479. The same clearly cannot be said here.

Respondents also argue that they were not required to specify that punitive damages would not be allowed, or to make some other express inclusion of the *Garrity* rule and that such a requirement would contravene the purpose of a choice-of-law clause as a means of incorporating

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(Resp. Br., p. 27). This argument further illustrates respondents' confused reasoning. Petitioners have not suggested that a choice-of-law clause incorporates only state law procedures rather than state substantive law, but, as stated *supra*, where state substantive law conflicts with the FAA, it is preempted.



an entire body of state law. (Resp. Br., pp. 17-20). Under the circumstances presented here, however, such a specific incorporation would be necessary to separately establish an agreement by the parties to forego the availability of punitive damages in order to circumvent the preemptive effect of the FAA on the New York law incorporated into the agreement. It should also be noted that respondents' argument in this regard is, at best, inconsistent; they suggest that a requirement of an express provision relating to the availability of punitive damages would pose significant questions regarding which rules must be expressly referenced and what is the point of a choice-of-law clause if there is an issue as to the state rules of law which it incorporates. (Resp. Br., p. 21). The

issue posed here is not the applicability of some general principle of New York law, but a principle of law which works in tandem with the comprehensive arbitration clause to foreclose the availability of punitive damages in arbitration. Respondents drafted the agreement, including the agreement to arbitrate, clearly with the intention of achieving this "waiver by implication" of any award of punitive damages against it.

Even more inconsistent is the following assertion of respondents:

> The petitioners' position would have the courts bend arbitration agreements in the direction of giving claimants the broadest possible benefits. The utility of arbitration depends on the willingness of parties to submit their disputes to the process. If the judicial approach is to put a thumb on the plaintiff's side of the scale in interpreting the agreement, resort to the process is at least as likely to be deterred



> as encouraged, especially when the remedy at issue gives arbitrators an uncontrolled and unreviewable discretion to assess punitive damages. (Resp. Br., pp. 23-24).

Simply put, respondents drafted the agreement and could have imposed upon petitioners an explicit restriction on the award of punitive damages, as they imposed a comprehensive arbitration agreement. Now, not having achieved the result which they believed they could achieve in their selected forum, respondents should not be heard to assert that they have not been treated fairly or to assert that resort to the arbitral forum [by broker/dealers] will be discouraged because arbitrators are seeking to render appropriate decisions, including decisions in favor of investor plaintiffs where warranted. The flaw in respondents' argument lies precisely in the fact that their

definition of fairness is apparently tied to their ability to prevail whether in the right or the wrong.[2]

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[2] Respondents also assert that permitting arbitrators to award punitive damages would discourage arbitration because it would give arbitrators "an uncontrolled and unreviewable discretion to assess punitive damages." (Resp. Br., pp. 23-24). Respondents' assertion ignores the fact that, in the first instance, they selected the forum. Further, there is no merit to the claim that excessive arbitral awards of punitive damages are "uncontrolled or unreviewable." Although the issue is not presented here, it would appear that where the amount of a punitive damages award was clearly excessive, arbitrary or capricious, it would be subject to review under either 9 U.S.C. §10(a)(2), as demonstrating "evident partiality" on the part of the arbitrators or, as the SEC suggests, under 9 U.S.C. §10(a)(4), as exceeding arbitral power. (SEC Br., p. 20, n. 14).

Respondents' amicus, the Securities Industry Association ("SIA"), attempts to interject an issue relating to possible due process concerns implicated by arbitral awards of punitive damages. (SIA Br., pp. 14-17). In their brief, however, respondents have not asserted that an award of punitive damages would violate their due process rights or claimed that the amount of the arbitrators' punitive



B. As The Seventh Circuit Acknowledged, The New York Choice-Of-Law Clause Is Inconsistent With The NASD Arbitration Rules.

Respondents further argue that the Seventh Circuit correctly concluded that the New York choice-of-law provision was

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damages award is excessive. Because a due process issue has not been raised by the respondents, nor passed upon by the District Court or the Court of Appeals, it is not properly raised by the SIA.

In any event, however, the SIA fails to address the fact that this Court has previously indicated that federal claims, under which treble damages with an acknowledgedly punitive aspect, may be arbitrated. (See Pet. Br., pp. 25-30). Moreover, respondents were given notice from the outset of this litigation that petitioners were seeking punitive damages, and it was the *respondents*, not the petitioners, who compelled arbitration and had a full and fair opportunity to resist petitioners' claim for punitive damages. Further, petitioners' claim for punitive damages was decided by a panel of three arbitrators "which was much less likely than a jury to be swayed by passion and prejudice." See *J. Alexander Securities, Inc. v. Mendez*, 17 Cal.App.4th 1083, 1095, 21 Cal.Rptr.2d 826 (Cal. Ct. App. 1993), *cert. denied*, _____ U.S. _____, 114 S.Ct. 2182, 128 L.Ed.2d 901 (1994).

controlling, notwithstanding provisions of the NASD rules which conflict with New York's prohibition against arbitral awards of punitive damages. The NASD Code of Arbitration Procedure states that it is "prescribed and adopted...for the arbitration of *any dispute, claim or controversy* connected with the business of any NASD member." (*Mastrobuono v. Shearson Lehman Hutton Inc.*, 20 F.3d 713, 717-718 (7th Cir. 1994); Pet. App., pp. 14-15). The Seventh Circuit also acknowledged that the NASD Arbitrators' Manual provides, "Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy." (*Mastrobuono*, 20 F.3d at 717-718 (7th Cir. 1994); Pet. App., p. 15). Respondents, however, argue that the only potentially applicable provisions of the NASD Code Of Arbitration (Sections



12(a) and 41(e)) are silent with respect to punitive damages and that the NASD Arbitrator's Manual is inapplicable because it is not incorporated into the Client's Agreement, is "merely a compilation of general information for the benefit of arbitrators," compiled by the Securities Industry Conference On Arbitration, and is not part of the NASD's rules of procedure. (Resp. Br., pp. 31-32).[3] The "any dispute, claim or controversy" language of Section 1 of the NASD Code of Arbitration Procedure is, however, clearly broad enough to encompass

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[3] The Seventh Circuit also apparently concluded that NASD Rule Of Fair Procedure 21(f)(4), which provides that "[n]o agreement shall include any condition which...limits the ability of the arbitrators to make any award" was applicable but concluded, nonetheless, that the New York prohibition against arbitral awards of punitive damages controlled. (*Mastrobuono*, 20 F.3d at 18; Pet. App., p. 17).

an award of punitive damages, and the provision of the NASD's Arbitrator's Manual clarifies that arbitral awards of punitive damages are contemplated under the NASD Code of Arbitration Procedure. Accordingly, under the federal policy requiring the resolution of any doubts concerning the scope of arbitral issues in favor of arbitration (*Moses H. Cone,* 460 U.S. at 24-25), as well as well-established contractual principles requiring the resolution of ambiguity against the drafter of a contract (*U.S. v. Seckinger,* 397 U.S. 203, 208, 90 S.Ct. 880, 25 L.Ed.2d 224 (1970); *Jacobson v. Sassower,* 66 N.Y.2d 991, 992, 499 N.Y.S.2d 381, 489 N.E.2d 1283 (N.Y. 1985)), the Client's Agreement should be read to permit an award of punitive damages.



Respondents' arguments to the contrary resort again to circuitous reasoning, arguing that the NASD rules require enforcement of the arbitration agreement, which in this case contains a New York choice-of-law clause and a provision that it is to be governed by the rules of the NASD or the Boards of Directors of the New York Stock Exchange ("NYSE") or the American Stock Exchange ("ASE"), as the customer may select. Respondents, however, cannot obviate the ambiguity of the Client's Agreement by focusing exclusively on one provision (the New York choice-of-law provision) and ignoring the provision giving rise to the ambiguity (the provision providing for arbitration pursuant to the rules of the NASD, the NYSE or the ASE.)

Further, respondents attempt to distinguish the decisions of the First, Eighth, Ninth and Eleventh Circuits, permitting arbitral awards of punitive damages, notwithstanding the inclusion of choice-of-law clauses naming states which did not permit arbitral awards of punitive damages, asserting that in each of those cases "the decision relied on the existence of AAA Rule 43 as overriding or at least creating a contradiction with the choice-of-law clause." (Resp. Br., pp. 33-34). Although the Courts of Appeal considered the fact that the agreements at issue provided for arbitration pursuant to the rules of the AAA in *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989),[4] *Lee v. Chica*, 983 F.2d

[4] In *Raytheon*, the First Circuit noted that the appellant had conceded that federal law controlled but, independent of this, adopted the view that "the contract's choice-of-law provision does not require us to determine the punitive damages question by looking to the law of the chosen forum (in this case, California). Rather, we, like [other courts], look to federal common law for our answer." *Raytheon*, 882 F.2d at 11, n. 5. The Court also concluded that the parties' adoption of the AAA rules further supported this conclusion.



883 (8th Cir. 1993), *cert. denied*, ___ U.S. ____, 114 S.Ct. 287, 126 L.Ed.2d 237 (1993), *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991), and, *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988), the Courts of Appeal found, apparently independently of that fact, that the FAA preempted the state law claimed to prohibit an arbitral award of punitive damages.

## III.

**THE ARBITRATORS DID NOT EXCEED THE SCOPE OF THEIR AUTHORITY IN AWARDING PUNITIVE DAMAGES AND THE SEVENTH CIRCUIT IMPROPERLY VACATED THE AWARD OF PUNITIVE DAMAGES UNDER SECTION 10(A)(4) OF THE FAA.[5]**

(Reply to Resp. Br., Pt. III, pp. 34-42).

Respondents contend that the SEC's argument that the Seventh Circuit (and the District Court) failed to give appropriate deference to the arbitrators' construction to the contract and that a claimed error in the arbitrators' interpretation of the contract does not constitute a basis for vacating their award, does not apply to

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[5] Petitioners' submit that this Court may appropriately consider the ground for reversal urged by the SEC (SEC Br., pp. 12-28), although not pressed by petitioners in their opening brief, it was raised in the courts below and has been presented by the SEC in their brief, with respondents having had the opportunity to respond, and is now adopted by petitioners as an alternative basis for reversal of the Seventh Circuit's decision.



the facts of this case. (Resp. Br., pp. 34-35). Respondents argue that "the arbitrators did not 'interpret the contract' for this purpose but instead found it unnecessary to consider the contract's language." (Resp. Br., p. 35). In support of this argument, respondents reference the fact that in their award, the arbitrators stated that the authority for their award of punitive damages could be found in Claimants' Response to Shearson's Brief In Opposition to Punitive Damages ("Claimants' Response"). In constructing their argument, however, respondents have taken from its context a single argument made in Claimants' Response and have disregarded other arguments made by petitioners' in support of the arbitrators' power to award punitive damages notwithstanding the New

York choice-of-law clause contained in the Client's Agreement. In response to respondents' citation to the decision in *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117 (2nd Cir. 1991), petitioners argued:

> Arbitration panels are thus not absolutely required to adhere to the letter of cases such as [*Barbier*]. This panel can and should do justice for the parties and apply the rules of law and equity as the arbitrators see them. The panel's decision should reflect the spirit rather than the letter of the law and of the parties' agreement. (Motion To Partially Vacate Award, Dkt. No. 58, Exhibit C, p. 2).

Additionally, petitioners cited *Willoughby Roofing & Supply v. Kajima International, Inc.*, 598 F.Supp. 353 (N.D. Ala. 1984), wherein the District Court concluded that a choice of law provision in a contract governed by the FAA designates only the substantive law that



the arbitrators must award in determining whether the conduct of the parties warrants an award of punitive damages but does not deprive the arbitrators of their authority to award punitive damages. (Motion To Partially Vacate Award, Dkt. No. 58, Exhibit C, p. 2). Petitioners also argued, among other things, that punitive damages awards were contemplated under the NASD Rules of Fair Practice and Arbitrator's Manual. (Motion To Partially Vacate Award, Dkt. No. 58, Exhibit C, p. 3). Under these circumstances, there is simply no basis for respondents' argument that the arbitrators did not base their conclusion that they could appropriately award punitive damages upon their interpretation of the Client's Agreement.

Further, contrary to respondents' claim that any purported interpretation of

the agreement which found that the *Garrity* rule was not controlling is outside of the bounds of a fair construction of the agreement (Resp. Br., p. 36), the arbitrators' construction of the contract was reasonable and should have been upheld by the Seventh Circuit. As discussed *supra*, the reference to the NASD rules contained in the parties' agreement gave rise to an ambiguity properly the subject of resolution by the arbitrators, and, just because the arbitrators failed to accept the interpretation asserted by respondents, does not render their construction untenable, unreasonable or subject to *de novo* review.

In support of their argument, respondents assert that this Court has "made clear that questions whether the parties have agreed to arbitrate and, if



so, what issues are included within that agreement, are for the court to decide, not the arbitrator." (Resp. Br., p. 40, citing *AT & T Technologies, Inc. v. Communications Workers of America,* 475 U.S. 643 (1986)). As the SEC points out in its brief, however, questions concerning the scope of arbitral authority with regard to matters conceded to be arbitral must be distinguished from issues relating to whether a particular claim is to be resolved by the arbitrator or the court. (SEC Br., pp. 17-18, n. 13). For example, a question whether an action brought by one of the petitioners for personal injuries sustained while on Shearson's premises while meeting with DiMinico with regard to an investment pursuant to the Client's Agreement might present a question of whether the action

is arbitrable. Such a question would be subject to judicial determination. On the other hand, the controversy at issue here, respondents' improper conduct in handling petitioners' account, clearly falls within the scope of the arbitration agreement, which provides for the arbitration of "any controversy arising out of or relating to [the Mastrobuonos'] accounts, to transactions with you...or to this agreement or the breach thereof..." (Pet. App., p. 44).

Moreover, here, petitioners' claims were submitted to arbitration at the behest of respondents, who, at the time they sought to compel arbitration, did not suggest that any of petitioners' claims were not arbitrable on the basis that punitive damages were requested or on any other basis. Now that the arbitrators, on



the basis of their construction of the contract which is neither unreasonable nor ignores the plain language of the contract,[6] have determined that they could properly award punitive damages, their determination should have been reviewed deferentially. Application of any other standard would render arbitration useless as a method of dispute resolution and would permit litigants, like respondents here, to insist on arbitration and, when dissatisfied with the results of the arbitration, to turn to a *de novo* ruling

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[6] If the language expressly prohibited an award of punitive damages, and the arbitrators nonetheless awarded punitive damages, then it would be clear that they had exceeded their power. Here, however, the arbitrators were entitled to construe the New York choice-of-law provision as designating the substantive law they were to apply in determining whether respondents' conduct warranted a punitive damages award, as did the Court in *Bonar*.

in a judicial forum in the hope that they will have better luck there.

**IV.**

**PETITIONERS HAVE NOT WAIVED THEIR RIGHT TO OBTAIN PUNITIVE DAMAGES. THEIR AGREEMENT TO A NEW YORK CHOICE-OF-LAW CLAUSE AND A COMPREHENSIVE ARBITRATION PROVISION DOES NOT CONSTITUTE A VOLUNTARY AND INTENTIONAL RELINQUISHMENT OF A KNOWN RIGHT.[7]**

Respondents initially argue that respondents had no right to recover

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[7] The SIA suggests that this definition of waiver as a voluntary relinquishment of a known right is not applicable here, stating, "While that standard may govern some waivers of constitutional rights, we know of no case invoking it to measure the validity of a commercial contract between private parties, and petitioners have cited none." (SIA Br., p. 22). The SIA is mistaken. As cited in petitioners' brief, in *Bonar*, the Eleventh Circuit applied the above-referenced standard in circumstances essentially identical to those presented here and concluded that there was no waiver. (Pet. Br., pp. 60-61). See also, *J. Alexander Securities, Inc., supra,* 17 Cal.App.4th 1083 at 1093-1094.



punitive damages in the first instance and, therefore, that they did not "waive" any such right, arguing, "If the right is supposedly conferred by some other state, what state - any state whose law happens to favor the petitioners' position?" (Resp. Br., pp. 42-44). Respondents further contend that petitioners "obviously do not mean [that they had such a right under] New York law, because New York law under the circumstances of this case provides that there is *no* right to punitive damages." (Resp. Br., p. 43; emphasis in original). Throughout the proceedings below petitioners asserted a right to recover punitive damages under their common law and statutory claims for, among other things, breach of fiduciary duty and violation of the Illinois

Consumer Fraud And Deceptive Practices Act.[8]

Respondents' argument confuses a right to recover punitive damages under New York law, which, at least with regard to petitioners' common law claims, supplied the substantive law that the arbitrators were required to apply in determining whether the conduct of the parties warranted an award of punitive damages (see *Bonar*, 835 F.2d at 1387), with a right to obtain an award of punitive damages in an arbitral forum.[9]

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[8] Respondents did not contest petitioners' ability to state claims under the Illinois Consumer Fraud And Deceptive Practices Act or under the Texas Deceptive Trade Practices-Consumer Protection Act, which permits the award of treble damages.

[9] It is not at all clear, as respondents argue, that "If the choice-of-law clause adopted the law of, say, Washington or Nebraska, states that do not allow punitive damages at all, petitioners' argument would be the same."



The decision relied upon by respondents throughout their brief and presumably the basis for their assertion that New York law does not afford a right to punitive damages under the circumstance presented, *Garrity v. Stuart*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976), did not hold that punitive damages could not be awarded under New York law, only that the courts had the exclusive power to award such damages. Further, respondents

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(Resp. Br., p. 44). Here, it is uncontested that New York law permits judicial awards of punitive damages. The basis of the Mastrobuonos' waiver claim is that they had an existing right to punitive damages under New York law, which respondents assert has been implicitly defeated by the Mastrobuonos' agreement to a comprehensive arbitration clause - it is the claimed tandem operation of the New York choice-of-law clause, with the general agreement to arbitrate, to destroy any right to punitive damages in any forum, which the Mastrobuonos assert is unconscionable.

have not contended in the proceedings before the District Court, the Seventh Circuit, or in this Court, that their conduct was not sufficiently egregious to warrant an award of punitive damages.

Respondents' suggestion that petitioners' have failed to appropriately preserve their argument that, if the New York choice-of-law clause and comprehensive arbitration clause are to be held to effect a waiver of any right to punitive damages, the Client's Agreement is unconscionable, also lacks merit. (Resp. Br., p. 45). Petitioners' argument is a corollary to their argument that there was no waiver, which has been pressed throughout the proceedings.

Nor can respondents defend against the unconscionability of their claimed "waiver by implication" by asserting there



is no separate action for punitive damages (Resp. Br., p. 46); the assertion that the Mastrobuonos are prohibited from seeking punitive damages in any forum is, after all, the very heart of the unconscionable nature of respondents' argument.

## CONCLUSION

For the foregoing reasons, petitioners respectfully request that this Court reverse the judgment of the Seventh Circuit Court of Appeals and remand this cause for confirmation of that portion of the arbitrators' award awarding petitioners punitive damages in the amount of $400,000 or, in the alternative, for a trial before the District Court on the amount of punitive damages or, in the further alternative, for a trial on petitioners' statutory and common law

claims giving rise to their claims for punitive damages.

Respectfully submitted,

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No. 94-18

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1994

Antonio C. Mastrobuono and
Diana G. Mastrobuono,

*Petitioners,*

v.

Shearson Lehman Hutton Inc.,
a corporation,
Nick DiMinico, Richard F. Benzer,
and Mark Stevenson,

*Respondents.*

## Motion for Leave to File Brief Amicus Curiae and Brief Amicus Curiae in Support of Petitioners

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MOTION FOR LEAVE TO FILE BRIEF
AMICUS CURIAE
AND
BRIEF AMICUS CURIAE

The Public Investors Arbitration Bar Association hereby respectfully moves for leave to file the attached brief amicus curiae in this case. The consent of the attorney for the Petitioners has been

obtained. The consent of the attorney for the Respondents was requested but refused.

The interest of the Public Investors Arbitration Bar Association in this case arises from the fact that its members currently represent public investors involved in securities arbitrations and related litigation actions pending before arbitration panels and state and federal courts throughout the United States, in which the same issue is before the Court, namely whether securities arbitration panels have the power to award punitive damages.

In the instant case in the Court of Appeals, Petitioners barely mentioned the public policy implications of the ability of arbitrators to award punitive damages, and also barely dealt with the issue of whether the agreement between the parties invoked the rule of New York law that prohibits arbitrators from awarding punitive damages.



Since it is likely that Petitioners may pursue the same course in this court, it is believed that the brief which amicus curiae is requesting permission to file will contain a more complete argument on the public policy issues and the invocation of the New York rule. If this argument is accepted, it could be dispositive of this case.

Respectfully submitted,

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## Interest of Amicus Curiae

It is the avowed purpose of the Public Investors Arbitration Bar Association ("PIABA") to create within the securities arbitration process what has been referred to as a "level playing field." PIABA is composed of attorneys from most of the 50 states who concentrate a significant majority of their practice in the representation of public investors throughout the 50 states. Members of PIABA have encountered the issue that is before this court in many arbitration and litigation proceedings throughout most of the 50 states and in many state and federal courts throughout the country.

## Summary of Argument

The Public Investors Arbitration Bar Association, as amicus curiae, urges this Court to reverse the decision of the court of appeals because punitive damages play an

important role in securities arbitration.[1]

The lower court, in its decision, failed to appreciate this important role. The decision below was based upon two conclusions:

(1) that New York law, viz. Garrity v. Lyle Stuart Inc., 40 N.Y.2d 354 (1976), impermissibly prohibits arbitrators from awarding punitive damages; and

(2) that the agreement between the parties must be read to invoke the rule of Garrity.

Each of these two conclusions, however, is built on a faulty foundation, and, for the reasons herein stated, as well as those

[1] PIABA is composed of attorneys that represent public investors in securities arbitration and related litigation actions in most of the 50 states and state and federal courts. The issue of whether arbitrators have the power to award punitive damages arises frequently in these proceedings.



stated by Appellant in its Brief, the decision below was in error and should be reversed.

**POINT I: NEW YORK'S GARRITY RULE IS AN UNWISE AND ANACHRONISTIC INTRUSION INTO THE PROVINCE OF THE ARBITRATOR, AND IS A HOLDOVER FROM AN ERA WHEN ARBITRATION WAS SUSPECT**

New York law, which ousts arbitrators of any authority to award punitive damages, is contrary to the principles that underlie the Federal Arbitration Act. See generally Southland Corp. v. Keating, 465 U.S. 1, 16 (1984) ("Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements"). See also Moses H. Cone Memorial Hospital v. Mercury Construction Corp., 460 U.S. 1, 25, n.32 (1983); Volt Information Sciences v. Board of Trustees for the Leland Stanford Jr. University, 489 U.S. 468 (1989).

Garrity v. Lyle Stuart, Inc., supra., upon which "New York law" and the decision below rests, was decided in 1976. Since

that time, arbitration has gained widespread acceptance as a fair, useful and sound method of dispute resolution. Indeed, this Court, which at one time displayed a hostility to arbitration similar to that of the Garrity Court, now views nearly all arbitration agreements as valid and enforceable.[2]

The arbitrators in Garrity had awarded the arbitration claimant $45,000 in compensatory damages and $7,500 in punitive damages after the arbitration respondent had walked out of the hearing dissatisfied with the certain preliminary rulings. The New York Supreme Court confirmed the award, and that decision was affirmed by the Appellate

[2]In fact, this Court once viewed pre-dispute arbitration agreements in securities fraud cases as unenforceable, see Wilko v. Swann, 346 U.S. 427 (1953), but that position has changed markedly in recent years. See Rodriguez de Queijas v. Shearson/American Express, Inc., 109 S.Ct. 1917 (1989); Shearson/American Express Inc. v. McMahon, 482 U.S. 220, rehearing denied, 483 U.S. 1056 (1987).



Division. The respondent, however, persisted in its appeal to New York's highest court, challenging only the punitive damage portion of the award. The Court of Appeals split 4-3, vacating the punitive damage award and rendering New York arbitrators powerless to award punitive damages.

Joan Garrity, the claimant in the arbitration, was the author of two successful books, and she alleged that the respondent, the books' publisher, had "maliciously" withheld royalty payments due her. The Court of Appeals, in ordering modification of the award, stated:

> An arbitrator has no power to award punitive damages, even if agreed upon by the parties. [citation omitted] Punitive damages is a sanction reserved to the State, a public policy of such magnitude as to call for judicial intrusion to prevent its contravention.

Garrity, 40 N.Y. 2d at 356. It is submitted that New York's policy in this regard is

antithetical to the federal policies encouraging the arbitrability of disputes.

The New York Court of Appeals expressed several motivations for its decision, all grouped under the general heading of "public policy." The court was obviously concerned that the free reign given to arbitral authority by the legislature and the courts might lead to punitive awards that are excessive and beyond the reach of the courts to correct.

This fear was underscored by the nature of the substantive claims involved in Garrity, i.e. breach of contract. It is of course well-established that punitive damages are not, as a matter of law, available in an action for breach of contract, no matter how willful or wanton the breach. Garrity, 40 N.Y. 2d at 358. Yet, as the Court observed in Garrity, arbitrators are not bound by such substantive legal provisions, and the courts



are not permitted to overturn an award based upon an error in applying substantive legal principles. Denying arbitrators the power to apply punitive damages was a logical way to correct the arbitrator's legal error.

But Judge Gabrielli, along with Judge Wachtler and Jones, dissented from the now-controversial ruling in Garrity. The dissenters criticized the majority for vacating a "rational and just award," 40 N.Y.2d at 360, thus suggesting that an irrational or unjust award could be vacated by the Court.

The majority decision in Garrity, however, goes beyond mere concern over the misapplication of substantive law. Rather, the Court's opinion bespeaks a blatant suspicion of the arbitral process, one that is difficult to reconcile with the strong current policies favoring arbitration.

Judged by the standards in effect seventeen years ago, the Garrity Court's

suspicion of arbitration was not inconsistent with the limited experience society had with commercial arbitration at the time. As stated, the Court's decision was also consistent with some of the then-existing federal misgivings about arbitration.

But the climate of distrust that gave rise to the federal decision in Wilko in the 1950's, and the New York decision in Garrity in the 1970's, no longer exists in the 1990's. It is thus not surprising that in virtually every forum outside New York, judicial hostility to Garrity has been overwhelming. Judges sitting in the federal courts located outside New York state have almost always seen fit to ignore it, sidestep it, or simply reject it out of hand, even in cases where the arbitration agreement involved contained a New York choice of law clause. See e.g., Raytheon Co. v. Automated Business Systems, Inc., 882



F2d 6 (1st Cir. 1989)(Reinhardt, J.); Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378 (11th Cir. 1988)(Kravitch, J.) Todd Shipyards v. Christensen, 943 F2d 1056 (9th Cir 1991).[3] Likewise, other state courts have with almost amazing uniformity refused to apply New York's limitation on punitive damages in arbitration.[4]

Importantly, virtually all courts now view the arbitration system differently from the way it was viewed in Garrity. As one court has stated on the issue of an

---

[3] See also Willis v. Shearson/American Express, Inc., 569 F. Supp. 821 (M.D.N.C. 1983) (H.Ward, J.)(holding that, even though the contract contained a New York choice-of-law clause, federal law favoring arbitrability supersedes the Garrity rule).

[4] See, e.g. Baker v. Sadick, 208 Cal.Rep. (1984); State Farm Fire & Casualty Co. v. Wise, 721 p.2d 674 (Ariz.App. 1986).
In addition, nearly all scholarly commentators have been critical of Garrity. See, e.g. Stipanovich, Punitive Damages in Arbitration - Garrity v. Lyle Stuart Revisited, 66 B.U.L. Rev. 953 (1986).

arbitrator's power to award punitive damages:

> [A]n arbitrator steeped in the practice of a given trade is often better equipped than a judge... to decide what behavior so transgresses the limits of acceptable commercial practice in that trade as to warrant a punitive award...

Willoughby Roofing and Supply Inc., v. Kajima International, Inc., 598 F.Supp. 353 (N.D. Ala. 1984), affirmed, 776 F.2d 269 (11th Cir. 1985).

More recently, the 1st Circuit, in Raytheon, supra, expressed the prevailing view:

> Punitive damages serve as an effective deterrent to malicious or fraudulent conduct. Where such conduct could give rise to punitive damages if proved in court, there is no compelling reason to prohibit a party which proves the same conduct to a panel of arbitrators from recovering the same damages.

Raytheon, at 10.



Indeed, even in New York, the Garrity rule has been criticized in the context of securities arbitration. In Matter of Dreyfus Service Corp. v. Kent, 183 A.D.2d 446, 584 N.Y.S2d 483 (1st Dep't.), Motion for Leave for Appeal Denied, 81N.Y. 2d 701, 594, N.Y.S. 2d 715, 610 N.E.2d 388, 1992, an intermediate level appellate court dutifully followed Garrity. But, in a separate concurring opinion, Justice Sidney Asch Wrote:

> if the Court of Appeals were to reexamine the issue of whether punitive damages can be awarded by an arbitrator in a securities dispute, it might well decide that changing times and circumstances mandate a reconsideration of the rule announced in Garrity....
>
> Under the present state of affairs, the danger represented in 'the uncontrolled use of coercive economic sanctions in private agreements' no longer refers to the ability of an arbitrator to impose punitive damages, but the inability of the investor to recover for real, and in some cases, glaring abuses.

N.Y.S. 2d at 484-485[5]

Garrity, of course, did not involve securities fraud, and it can be distinguished from the instant matter based upon that fact. Indeed, the differences between ordinary commercial arbitration based on breach of contract and securities arbitration based, for the most part, on fraud, presents important grounds for not applying Garrity to securities arbitration.

Punitive damages play a necessary and important role in securities arbitration. When awarded at the conclusion of a matter,

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[5] Like the case at bar, the Kent arbitration involved a dispute over fraud and misrepresentation in the sale of securities. The arbitrator who heard the dispute considered the evidence, and determined that a case had been made for punitive damages. No claim was made that the arbitrator's award was irrational, without merit or that it was excessive. Rather, Dreyfus only claimed, and the Appellate Division determined, that Garrity's precedential force mandates vacatur of the arbitrator's award insofar as punitive damages are concerned. The New York Court of Appeals denied the motion for leave to appeal.



punitive damages serve as a deterrent to similar unlawful conduct. And at the outset of a case, the prospect that punitive damages might be awarded can motivate a transgressor promptly to offer adequate compensation or a fair settlement for the wrong that has been committed.

The rule of Garrity should not be applied to securities arbitration because punitive damages are necessary to police adequately the securities industry, where deterrence of wrongful conduct and the benefits of early settlement are especially important. The securities industry is involved in the sensitive fiduciary task of giving financial advice and investing other people's money on a commission basis. If a brokerage firm is assessed punitive damages for knowingly fraudulent or grossly negligent behavior, the firm is likely to cease and desist from such offensive conduct. Conversely, if the securities

industry is insulated from the dangers of punitive damages, (as it is under Garrity), there will be far less deterrence, and, consequently, a greater number of abuses.

Miley v. Oppenheimer & Co., 637 F.2d 318, 330 (5th Cir. 1981), was one of the first appellate cases upholding a jury verdict of punitive damages against a securities firm. As the Fifth Circuit explained in Miley, relying in part on the work of one of the authors of this brief;

> Most courts in the past have seen fit, when they find the broker-dealer's hand in the till, to simply request removal of the offending appendage. And when the till is empty, and the broker-dealer's fingerprints are all that remain where the money once lay, all the courts do is to require the crook to replace the booty. If ever there was a situation where crime pays it is in such circumstances;...No wonder one commentator saw fit to term the average recovery in churning cases as creating for the broker-dealer a "low risk larceny."
> ...[T]he only sure way of deterring such conduct in the future is to take the profit away from the wrongdoers and slap on an additional amount as punitive damages;...



> Goldberg, Fraudulent [Broker]-Dealer Practices, sec.6.5 (1978).

Miley, 637 F.2d at 331-32.

Logic similar to that used by the Fifth Circuit in Miley has been used time and again by other courts reviewing punitive damage assessments against brokerage firms. See, e.g., Raytheon, supra. In the post-McMahon era, even though juries have been preempted from considering punitive damage verdicts against securities firms because such cases are now heard in arbitration, the force of Miley, that punitive damages provide much-needed deterrence, is still very much appropriate. If the type of deterrence that motivated the Miley court is to be achieved in the post-McMahon era, the rule of Garrity must not be extended to securities arbitration.

A vivid example of the deterrent effect that punitive damage awards can have on the securities industry took place in the summer of 1988. During that summer, arbitrators in

two separate arbitrations awarded investors a total of over $2.5 million in punitive damages against Dean Witter Reynolds, Inc. See Matter of Mark & Traczyk v. Dean Witter Reynolds, Inc. (AAA Fla. 7/29/88) and Matter of Hutcheson v. Dean Witter Reynolds, Inc., (AAA Fla. 8/12/88) summarized in Goldberg, 1991 REPORT OF THE PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION AS TO THE AUTHORITY OF ARBITRATORS TO AWARD PUNITIVE DAMAGES IN SECURITIES ARBITRATION (1991), at 18-21. Both these arbitrations were decided by panels of the American Arbitration Association sitting in Florida. Both matters focused on the unsuitability of naked index options in the accounts of an elderly couple (Mark & Traczyk) and a recently widowed housewife (Hutcheson).

Just six days after the second award, Haskell T. Adler, southern regional manager for Dean Witter, issued a memo dated August 18, 1988 to "Florida Regional Managers" on



the topic "Florida Regional Options Policy."

The memo stated:

> Effective immediately, the only types of options activity that will be permitted in the Florida Region will be the following:
>
> 1. The selling (writing) of covered equity calls. To be considered covered the equities underlying the calls must be on deposit in the account or be purchased at the same time the calls are sold, or they must be backed by escrow receipts in approved accounts.
>
> 2. The selling (writing) of cash secured equity puts. In this case there must be on deposit in the account a cash amount equal to the value of the strike price of the put sold.
>
> Example: Client sells 1 XYZ August 40 put.
>
> Strike price of put $40
> X 100 = $4,000
> requirement.
>
> Any account engaged in this type of activity must be interviewed by the branch manager and a memo regarding the account's suitability to engage in the selling (writing) of cash secured equity puts must accompany the Option Client Information form which is to be sent to the Regional Director for final approval.

3. The purchase of Put or Call Index Options.

4. The purchase of Put or Call Equity Options.

Any account executive who violates this policy will be subject to disciplinary action up to and including termination.

The deterrent effect of the punitive damage awards is obvious. The activity prohibited by the Adler memo is precisely the activity involved in the two arbitrations. With the advent of the Dean Witter prohibition and screening process, elderly and unsophisticated investors are far less likely to be harmed by similar practices at Dean Witter. Without the punitive damage awards, the practice might well have continued, causing untold losses to other innocent investors.

Punitive damages thus play a crucial role in policing the securities industry. The ever-contracting budgets of governmental watchdogs makes public policing alone impractical and far too sporadic. But



public investors, acting as private attorneys-general, can play a useful part in deterring securities fraud. If the rule of Garrity is retained in securities arbitration, such non-governmental policing will cease to exist, and investors will be less safe from those who might wantonly or willfully like to part them from their money.

The importance of deterrence notwithstanding, the members of the Public Investors Arbitration Bar Association are especially concerned with the important role punitive damages play in the settlement of disputes. Our collective experience is that in many situations, it is impossible to reach an expeditious and just settlement in cases where punitive damages are not available. And unfortunately, securities arbitration cases frequently involve elderly customers who have lost all or a substantial

part of their life's savings.[6] In such cases, expeditious and just settlement is especially important.

If arbitrators are not empowered to award punitive damages, brokerage firms have minimal incentive adequately to settle just disputes. If Garrity is extended to securities arbitrations, brokerage firms will know in advance that the worst they can do in arbitration is to be forced to make restitution; their incentive to make that restitution prior to hearing and award will be all but eliminated. Instead, brokerage firms often offer settlements that are smaller than the amount justly deserved, knowing that the investor must then face the difficult choice of (1) taking the lesser sum, or (2) incurring significant attorneys

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[6] An example of this is the NASD arbitration case of Peterson v. Shearson (NASD - AZ '89) which resulted in a punitive damage award of $1,000,000 which was paid in full. The arbitrator's case summary began with the following sentence: "Peterson is a 100 year old widow with impaired vision."



fees, expert witness fees and arbitral forum fees in order to obtain restitution (less the costs of the proceeding).[7]

The possibility of punitive damage awards reduces the likelihood that brokerage firms will commit "extortion by arbitration." The prospect of punitive damages awards has a useful impact on dispute control and the encouragement of just settlements, and punitive damages should not be eliminated through the insertion of an innocent-looking choice-of-law clause into a consumer contract of adhesion.

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[7] The prospect of this type of conduct occurring in the setting of litigation is reduced not only by the availability of punitive damages, but also by the possibility of the imposition of sanctions by the court. In this regard, it is worth noting that arbitrators lack the power to "sanction" participants for misbehavior or for making legal and factual arguments that are frivolous, baseless and without any merit. See, e.g. A.G. Edwards & Sons v. McCollough. No. M90-129-PHX-PGR, slip op., (D.Ariz. May 2, 1991)(Rosenblatt, J.)

The need for punitive damages in securities cases is best summed up by recounting a statement made in Aldrich v. Thomson, McKinnon Securities, Inc., 746 F.2d 243, 246 n.3 (2d Cir. 1985)(Lumbard, J.).

> Thomson McKinnon's wanton and reckless disregard of the trust placed in it by Aldrich was not only a wrong against her but, by what it portended for other unfortunate investors, it was a wrong against the general public. Thomson McKinnon, a seller of securities on national exchanges and over the counter, a member of the New York Stock Exchange and other leading exchanges, is a large, highly regulated, and socially significant institution. ...[T]he purpose of the punitive damage award is to punish and deter the offender...[and to] discourage repetition of Thomson McKinnon's grossly negligent conduct, or instances of such conduct by other brokerage firms.



Id. at 249.[8] The deterrent effect just-described would be lost if the rule of Garrity is permitted to operate nationally in the context of securities arbitration.

## POINT II: IT IS UNCONSCIONABLE TO ALLOW THE SECURITIES INDUSTRY TO USE THE NEW YORK CHOICE OF LAW CLAUSE IN ITS CONTRACTS OF ADHESION TO INSULATE ITSELF FROM PUNITIVE DAMAGE AWARDS

The members of the securities industry almost uniformly require that customers sign a pre-printed "Customer Agreement." The Appellant here was such a customer. The standard "Customer Agreement," like the agreement in the case at bar, invariably has two clauses of significance. The first calls for arbitration, typically before one or more industry self-regulatory

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[8] While the approach of Garrity has been followed in Indiana, School City of East Chicago, Indiana v. East Chicago Federation of Teachers, 422 N.E.2d 656 (Ind.App. 1981)(Gerrard, J.), West Virginia, Anderson v. Nichols, 359 S.E.2d 117, 121, n.1 (W.Va. 1987)(Nealy, J.), and New Mexico, Shaw v. Kuhnel & Associates Inc., 698 p.2d 880, 882 (1985)(Riordan, J.), none of these cases involved securities arbitration.

organizations; the second states that New York law shall govern any controversy. These two clauses then work together (in a somewhat surreptitious way) to insulate the industry from effective policing by private attorneys general. This Court should not sanction such a practice.

In Garrity, the New York Court of Appeals expressed a concern about permitting arbitrators to award punitive damages because their selection can be "restricted or manipulat[ed] by the party in a superior bargaining position." This fear, however, has no application to investor-initiated securities arbitration, because, almost invariably, when punitive damages are awarded in connection with claims brought by public investors, the punitive damages are awarded to the investors against the brokerage firms.

Needless to say, in securities arbitration, it is the brokerage industry



that holds the superior bargaining position, and it was the brokerage industry that was the driving force behind compulsory arbitration of securities disputes. On June 8, 1987, when the United States Supreme Court reversed its thirty-four year tradition of federal judicial hostility toward arbitration of securities disputes, and held that an arbitration agreement in an investor-broker contract was binding on the investor, the appeal was brought by a securities firm, and the Securities Industry Association supported that position by filing a brief as Amicus Curiae. See Shearson/American Express Inc. v. McMahon, 482 U.S. 220, rehearing denied, 483 U.S. 1056 (1987).

In most cases, the arbitration agreements in broker-customer agreements permit arbitration only before the various self-regulatory organizations of which the firm is a member. The arbitrations thus

take place in the brokerage firm's proverbial backyard, where the customer can exert little influence and there is scant chance for the evil manipulation to occur. Even in the (rare) case where securities arbitration is not before a self-regulatory organization, it takes place before the American Arbitration Association, which boasts a long history of impartial resolution of disputes.[9]

In short, the "evil manipulation" rationale for Garrity cannot logically be applied to securities arbitration in the 1990s. Thus, while Garrity might still have validity in some contexts, it simply should not be applied to securities arbitrations, especially those conducted in states that permit arbitrators to award punitive damages.

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[9] And as added insurance against manipulation, most securities arbitrations, whether held before the SROs or the AAA, have a member or affiliate of the brokerage industry on the panel.



Yet another underpinning of the rule of Garrity is that arbitration should not be permitted to replace the State as the "engine for imposing a judicial sanction." But the securities industry, through its dogged advocacy of arbitration as the exclusive mechanism for the adjudication of public investor grievances, has left the State judiciary no role in the process of resolving broker-customer disputes. See Shearson v. McMahon. supra. It is also noteworthy that in McMahon, the Supreme Court specifically took from the courts, and gave to arbitrators, the power to determine R.I.C.O. claims in public investor disputes, including claims for treble damages under that statute.

That same industry now urges that Garrity be exported to include securities arbitration awards in states that decline to follow the rule. In so doing, the industry seeks to insulate itself from effective

punishment. Having succeeded completely in replacing the State and Federal judiciary as the "engine" for the adjudication of customer disputes, the securities industry now employs Garrity to prevent awards of punitive damages against themselves.

The use of Garrity, within the monopolistic area of securities arbitration, is less than ethical because it constitutes an indirect way of violating rule 21(f)(4) of the N.A.S.D.'s Rules of Fair Practice, which mandates that: "No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." Thus, while no brokerage firm could write a pre-dispute arbitration clause that directly states that "no customer can obtain punitive damages in securities arbitration," that same result is



achieved through the indirect device of putting a New York choice-of-law clause into a national securities contract which then seeks to govern millions of public investors who have no other contact with the state of New York other than the aforesaid clause in their brokerage contracts. In addition, efforts by such self-regulatory organizations as the NYSE to include a punitive damages section in their standard arbitration award form are rendered a nullity by the express reference to New York law (and implicit invocation of Garrity) in the standard brokerage contract.

Today, the members of that same industry, armed with a monopoly over adjudication of customer disputes, seek to utilize the agreements they have extracted from their customers to insulate themselves from punishment for such torts as breach of fiduciary duty and the most invidious kinds of frauds. Now that the United States

Supreme Court has virtually foreclosed the possibility of litigation of broker-customer disputes, arbitration must assume the role of judge, jury and policemen in resolving claims against the brokerage industry.

To compound matters, it must be noted that the securities industry knows that the laws of states other than New York permit punitive damage awards by arbitrators. For this reason, many members of the industry actively seek to impose the New York view on non-New York claimants by placing New York governing law provisions in their standard form contracts they make their customers sign.[10] Clearly, the inclusion of such a provision is intended to extend the rule of Garrity across the nation. By imposing Garrity on the perhaps-unwilling, out-of-

[10] On the other hand, customers of brokerage firms know nothing about the rule of Garrity, and they are thus likely to be surprised when they learn that New York's Garrity rule forecloses any award of punitive damages.



state participants in the securities arbitration process, New York law becomes the shield that the securities industry uses against claims of securities fraud.[11] And by designating New York law as governing, (often adding language "without giving effect to New York's conflict-of-laws provisions,") they seek to disenfranchise the judiciary of other states and the consumer protection laws of those states (regardless of the anti-waiver provisions contained therein), and compel application of Garrity even in states that reject it.

This Court should decline to participate in this disenfranchisement. Members of the securities industry know that a provision in their contracts which would expressly provide that a state's consumer

[11] Indeed, to the extent that other jurisdictions, with or without a New York choice-of-law clause, have declined to adhere to Garrity, New York's Garrity rule becomes the source of conflict with the law of other jurisdictions.

protection laws would not govern the transaction would be void if that state's law contained an anti-waiver provision. The securities industry instead inserts a New York choice-of-law clause in their agreements and makes the same otherwise prohibited argument that the remedy of punitive damages has been waived by the investor.

This Court should reverse the decision below because it is unconscionable to permit the New York choice-of-law clause, contained in a consumer contract of adhesion, to insulate the securities industry from the deterrent effect of punitive damage awards.



## Conclusion

For the reasons stated here, the Public Investors Arbitration Bar Association, as amicus curiae, urges this Court to reverse the decision of the court of appeals.

Respectfully submitted,

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I hereby certify that three (3) copies of the foregoing has been served upon the following Counsel of Record by United States Mail, postage prepaid on this 15th day of November, 1994:

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NOV 15 1994

No. 94-18

# In the Supreme Court

OF THE

**United States**

OCTOBER TERM, 1994

ANTONIO MASTROBUONO, ET UX.,
*Petitioners,*

vs.

SHEARSON LEHMAN HUTTON, INC., ET AL.,
*Respondents.*

On Writ of Certiorari to the United States
Court of Appeals for the Seventh Circuit

## MOTION AND BRIEF AMICUS CURIAE OF AMERICAN ASSOCIATION OF LIMITED PARTNERS IN SUPPORT OF PETITIONERS

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40 pp

## MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Pursuant to Rule 37.4 of the Rules of this Court, the AMERICAN ASSOCIATION OF LIMITED PARTNERS, through its counsel, respectfully moves this Court for permission to file a brief *amicus curiae* in this action. The proposed brief is printed with and follows this motion.

In support of this motion, applicant states the following:

1. This brief is proffered to the Court in order to bring relevant matter to its attention that has not been brought to its attention by the parties.

2. Applicant is an independent, not-for-profit national organization based in Washington, D.C. It was founded in 1990, and has approximately 3500 members. It seeks to act as an advocate on behalf of limited partners and other investors to ensure fairness in financial investments, and to provide investors with educational knowledge and materials. Applicant has testified before Congress, and has been widely quoted in major national financial publications.

3. Applicant's interest in this case stems from its overall mission of investor protection and promotion of principles of fairness in the investment marketplace.

4. Counsel for applicant has previously appeared before this Court as *amicus curiae*, by motion, in Plaut v. Spendthrift Farm, Inc., No. 93-1121.

5. In order to ensure this brief conforms with Rule 37.1 of this Court, counsel has reviewed the opinion of the Court of Appeals, and has spoken with petitioners' counsel as to the matters raised below. Based thereon, applicant believes this brief fully comports with Rule 37.1. For the reasons set forth in the brief, applicant also believes the legal issues discussed are properly before the Court, and are necessary to resolve in order to decide the cause.

6. Applicant files this motion because not all parties have consented to the filing of this brief. Petitioners have consented, while respondents have declined to consent.

For the foregoing reasons, applicant respectfully asks that its motion to file a brief *amicus curiae* be granted.

I declare under penalty of perjury of the laws of the United States that the facts set forth herein are true and accurate to the best of my personal knowledge.

Dated this 14th day of November, 1994.

Respectfully submitted,

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## INTEREST OF AMICUS CURIAE

The American Association of Limited Partners (AALP) is an independent, not-for-profit national organization based in Washington, D.C. It was founded in 1990, and has approximately 3500 members. It seeks to act as an advocate on behalf of limited partners and other investors to ensure fairness in financial investments, and to provide investors with educational knowledge and materials.

AALP is committed to protecting investor rights where such rights are being abused or threatened. AALP has testified before Congress, and has been widely quoted in major national financial publications.

AALP believes this case is one in which investor rights are in fact being threatened, and which creates a great potential for abuse of those rights. As a result, it seeks to bring before this Court matters that relate directly to its mission of fairness in the investment marketplace. In AALP's opinion, this case is much more than what the Court of Appeal perceived it as, a mere choice-of-law dispute. It instead involves far greater issues of investor protection that need to be addressed, based on strong legal as well as policy reasons. AALP appreciates the opportunity to present its views to this Court.

## SUMMARY OF ARGUMENT

First. The NASD is bound by section 19(g)(1) of the Securities Exchange Act of 1934 to comply with and enforce Rule 21(f)(4) of its Rules of Fair Practice. As a result, NASD arbitrators are bound under section 19(g)(1) to refuse to give effect to any private agreement purporting to limit their ability to make any award. Any provision seeking to bind the

NASD to waive such compliance with section 19(g)(1), such as the one in this case, is rendered void by Section 29 of the Exchange Act. This result especially follows from the premises of the federal securities laws and this Court's decision in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), which include integrity of self-regulatory organization (SRO) rules and nonwaiver of substantive rights in arbitration. Those premises must be maintained fully intact, lest the carefully balanced system of laws which ensures the fairness of SRO arbitrations to the public investor be seriously undermined.

Second. Petitioners had the right to demand arbitration directly under the NASD Rules, without any reference to the arbitration agreement; as a result, the arbitration agreement is irrelevant and moot, and should not be the basis of any enforced waiver of rights. Furthermore, there is no language in the Customer's Agreement specifically stating that petitioners were waiving any rights or even mentioning those rights, and no contractual waiver of rights should be enforced unless it is clear a party knows it is making a waiver. That is especially true here, as the purported waiver is in a preprinted agreement between parties of unequal bargaining power, there is no language indicating a waiver of any sort, and there was no consideration for the waiver because petitioners had exactly the same right to arbitration with or without the arbitration agreement. Finally, enforcement of a waiver implied solely from interpretation of caselaw in a jurisdiction that is the subject of a choice-of-law clause would have atrocious practical consequences for millions of people, and especially investors, who must engage in commercial transactions in which a choice-of-law clause is imposed on them.



## ARGUMENT

### I. The Attempted Punitive Damages Prohibition Is Rendered Void By Exchange Act Sections 19(g) And 29(a), Since It Purports To Prevent The NASD From Complying With And Enforcing Its Own Rules

This case is much more than a mere "difference over the proper interpretation of the choice of law clause." Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 709 (7th Cir. 1994). It is governed firstly by the federal securities laws. Section 29(a) of the Exchange Act operates to void any provision seeking to prevent the NASD from enforcing and complying with its own rules, such as the one at issue here.

#### A. Applicability Of Exchange Act Sections 19(g) And 29(a)

Section 19(g)(1) of the Exchange Act, 15 U.S.C. § 78s(g)(1), requires that a registered securities association "shall comply with the provisions of this chapter, the rules and regulations thereunder, and its own rules, and . . . absent reasonable justification or excuse enforce compliance . . . with such provisions . . . by its members and persons associated with its members . . . ." (Emphasis added.) The NASD, the body that conducted the arbitration at issue in this case, is a registered securities association. 15 U.S.C. § 78o-3; Sorrell v. SEC, 679 F.2d 1323, 1325 (9th Cir. 1982); Todd & Co. v. SEC, 557 F.2d 1008, 1011-12 (3d Cir. 1977).

The provisions of section 19(g)(1) are obligatory. A self-regulatory organization shall comply with its own rules, and shall enforce compliance with its rules by its members and associated persons. As the Seventh Circuit has

recognized, section 19(g)(1) "expressly requires an exchange to comply with, and enforce compliance by its members with, its own rules. . . . [I]t is clear that Congress intended . . . Sec. 19(g)(1) to impose an affirmative legal duty upon registered exchanges." Spicer v. Chicago Board of Options Exchange, Inc., 977 F.2d 255, 259 (7th Cir. 1992).

The Court of Appeal's decision is explicitly based on its interpretation of Art. III, Sec. 21(f)(4) of the NASD Rules of Fair Practice (hereinafter "Rule 21(f)(4)"), and its opinion that Rule 21(f)(4) did not prevail over New York law to the contrary. Mastrobuono, 20 F.3d at 717-18. Rule 21(f)(4) provides that "[n]o agreement shall include any condition which . . . limits the ability of the arbitrators to make any award" (emphasis added). Mastrobuono, 20 F.3d at 718.

This is a rule of a self-regulatory organization. Accordingly, under section 19(g)(1), the NASD must comply with it, and enforce compliance with it by members and associated persons. The NASD has an "affirmative legal duty" to do so. Therefore, the NASD is obligated to enforce and comply with Rule 21(f)(4) and its prohibition against arbitration agreements which purport to limit its arbitrators' power to render any award.

Because Exchange Act section 19(g)(1) requires that the NASD must enforce compliance with all of its rules, including Rule 21(f)(4), the contrapositive is true as well. Exchange Act section 19(g)(1) prohibits the NASD from not enforcing compliance with Rule 21(f)(4), just as it prohibits the NASD from not enforcing compliance with any of its other rules. It also prohibits the NASD from failing to comply with Rule 21(f)(4). Section 19(g)(1) thus prohibits the NASD from treating an agreement purporting to limit arbitrators'



power to render any award—one in direct violation of Rule 21(f)(4)—as fully valid, proper and enforceable.

Put differently, under section 19(g)(1), the NASD must always retain full power to take whatever action it deems necessary, against a private agreement that contravenes Rule 21(f)(4). Furthermore, because the NASD must also comply with its own rules, it must ensure that no agreement operates to limit arbitrators' power in the prohibited manner—exactly what Rule 21(f)(4) specifies. Its arbitrators can, and are duty-bound to, refuse to give effect to such a private agreement purporting to nullify their power.

Section 29(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc(a), provides (emphasis added): "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be **void**." In turn, Exchange Act section 3(a)(9), 15 U.S.C. § 78c(a)(9), defines "person" broadly as including a natural person, company, government, or political subdivision, agency, or instrumentality of government. See also In re Washington Public Power Supply System Securities Litigation, 623 F.Supp. 1466, 1479-80 (W.D. Wash. 1985).

The National Association of Securities Dealers, Inc. is a corporation, see NASD Certificate of Incorporation, NASD Manual ¶ 1003, and it is an entity carrying on a commercial enterprise. In other words, it is a "company." See, e.g., Black's Law Dictionary 281 (6th ed. 1990). It is thus a "person" under the Exchange Act.

Thus, under Exchange Act section 29(a)(1), any provision binding a person such as the NASD to waive

compliance with any provision of the Exchange Act (Chapter 2B of Title 15 of the U.S. Code) is void. Section 19(g)(1), the statute requiring the NASD to comply with and enforce its own rules, is such a provision.

What section 29(a)(1) renders void is exactly what respondents' interpretation of the customer's agreement does. By entering into a private agreement that purports to prohibit the NASD from complying with and enforcing Rule 21(f)(4), respondents also seek to bind the NASD to waive compliance with Exchange Act section 19(g)(1).

As a result, even if the "New York law" provision of the customer's agreement meant what respondents want it to, it would still be **void** by virtue of section 29(a)(1), to the extent it attempts to prohibit the NASD from complying with and enforcing Rule 21(f)(4). It is therefore void to the extent it purports to prohibit arbitrators from making any award under that Rule. Respondents claim, and the Seventh Circuit held, that the New York choice-of-law provision in the customer agreement "trumps" Rule of Fair Practice 21(f)(4). Mastrobuono, 20 F.3d at 717-18. But Exchange Act section 29(a)(1) "overtrumps" the choice-of-law provision on the punitive damages issue.[1]

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[1] The one/three year statute of limitations in section 29 is not relevant to this case. First, it only applies to actions regarding violations of rules or regulations prescribed under 15 U.S.C. § 78o(c)(1) or 78o(c)(2), which are not at issue in this dispute over whether punitive damages may be awarded. Second, it applies only to actions maintained in reliance on section 29, and is thus by its terms not applicable to solely defensive measures to avoid another party's attempt to enforce a contract in violation of the Exchange Act, which is what petitioners are engaging in here.



Simply put, respondents cannot use a private contractual provision as a means of prohibiting the NASD from complying with and enforcing its own rules. Had Shearson's preprinted customer's agreement been more direct and explicitly said, "This agreement requires the NASD not to comply with or enforce Rule 21(f)(4) and thereby prohibits it from awarding punitive damages in any NASD arbitration," the applicability of sections 19(g)(1) and 29(a)(1) would be obvious. It should be no less so when respondents have tried to accomplish exactly the same thing through a more roundabout method.

B. Further Considerations Under The Federal Securities Laws

That section 29 applies to void the purported punitive damages waiver is not merely fortuitous. It is, rather, part of a central purpose of the federal securities laws, which is to protect the investing public and to ensure that the self-regulatory organizations actively effectuate that vital purpose.

The beneficiary of the 1934 legislation was intended to be the public investor, and the Exchange Act was enacted "'for the purpose of bringing safety to the general public in the field of investment and finance. . . . It is in the light of the interests of the general public that the bill was drawn.'" Lank v. New York Stock Exchange, 548 F.2d 61, 65 (2d Cir. 1977) (quoting H.R. Rep. 1383, 73d Cong., 2d Sess. 15 (1934)).

The federal securities laws leave the implementation of that important purpose to the securities self-regulatory organizations, subject always to the oversight of the SEC. "The primary purpose of the Exchange Act was to protect customers of the stock exchanges, that is, public investors.

One method of effectuating this was to impose on the exchanges a statutory duty 'to protect investors by regulating [the exchanges'] members. . . .' Lank v. New York Stock Exchange, 548 F.2d at 64 (quoting Note, Exchange Liability for Net Capital Enforcement, 73 Colum. L. Rev. 1262, 1264).

As long as the SROs are able to fulfill this vital obligation, the SEC's oversight power need not come into play. Conversely, if the power of an SRO to protect investors is impaired, the federal laws will operate to eliminate the impairment. "[T]he Senate Committee Report stressed that 'the initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs remain within the exchanges themselves. It is only where they fail adequately to provide protection to investors that the Commission is authorized to step in and compel them to do so.'" Silver v. New York Stock Exchange, 373 U.S. 341, 352 (1963) (quoting S. Rep. No. 792, 73d Cong., 2d Sess. 13 (1934)).

The NASD, like the other major SROs, has set up an elaborate system of rules to ensure that broker-customer disputes can be settled simply and fairly through arbitration, without any sacrifice of the customer's substantive rights. In addition, the NASD is still an organization of securities firms, and it is crucial that there be both fairness and a perception of fairness in the conduct of arbitrations that involve a member firm. The existence of SRO rules and procedures, with the SEC's statutory duty of approval to ensure their adequacy, are precisely why this Court held in McMahon that arbitration procedures amply ensure fairness to public customers. Id., 482 U.S. at pp. 233-234.

Thus, the current system of arbitration procedures reflects a careful balance between the desire for simplified



dispute resolution, and a need to ensure that the goals of investor protection embodied in our federal securities laws are fulfilled. That system is set in place by both the SEC's approval of the NASD's rules of arbitration, under Exchange Act section 19(b)(1) [15 U.S.C. § 78s(b)(1)], and the NASD's statutory charge under Exchange Act section 19(g) to enforce and comply with those rules.

Respondents seek to undo this carefully balanced SEC-approved system. Were respondents' arguments to prevail, a member firm could override any SRO rule it wanted to, as long as it could get the other party to "agree" to it (even if the "agreement" were nothing more than a boilerplate preprinted customer's agreement, see infra Part II(B)(1)). That defeats the entire purpose and structure of the self-regulatory mechanism, by which the SRO enforces its rules against members who seek to act contrary thereto. It also defeats the overall Congressional paradigm. The integrity of the SRO rules is a central part of the whole structure of the federal securities laws, and it neither can nor should be changeable at the instance of a member firm, especially by means of a preprinted customer's agreement.

It is also worth stepping back to see how different this case is from Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), a case in which similar issues arose in a much different factual context. For example, in McMahon, this Court held that section 29(a) did not forbid waiver of section 27 of the Exchange Act [15 U.S.C. § 78aa] because "Sec. 27 does not impose any statutory duties." McMahon, 482 U.S. at 228. By contrast here, section 19(g)(1) does

impose statutory duties, and any attempt to override it is subject to the prohibitions of section 29(a).[2]

In addition, McMahon rested on the principle that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute [, and thus] the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights." Id., 482 U.S. at 229-230, 232. But that is exactly wrong in this case, because under respondents' view, petitioners are barred from remedies in arbitration that they would have in a court of law. Under respondents' view petitioners by agreeing to arbitrate their state-law claim have in fact foregone substantive rights.

If nothing else, this Court should be chary of enforcing the purported waiver of substantive rights in the manner sought by respondents, for the reason that the fundamental premises of McMahon do not exist in this case.

While arguments based on Exchange Act sections 19 and 29 have apparently not been raised until now, that should not matter. Since the choice-of-law provision is void to the extent it purports to prohibit punitive damages, a federal court has no jurisdiction to give it any effect; something that is void is a nullity and does not exist in contemplation of the law. See also 9 U.S.C. § 2. Absence of subject matter

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[2] In addition, McMahon generally relied on the SEC's "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs, id., 482 U.S. at 233, a presumption which in turn rested on the SEC's statutory power to approve all SRO rules and rule changes. Respondents, however, seek to effect a *de facto* nullification of this SEC power, by what amounts to a private cancellation of Rule 21(f)(4) for purposes of this case—and many more like it—without the approval of the SEC that is statutorily required for an SRO rule change.



jurisdiction to enforce this void provision may be raised at any time, even for the first time to this Court. Clark v. Paul Gray, Inc., 306 U.S. 583, 588 (1939); Dunton v. County of Suffolk, 729 F.2d 903, 910 (2d Cir.), modified on other grounds, 748 F.2d 69 (2d Cir. 1984). Subject matter jurisdiction to enforce a void provision is also lacking because of the absence of a substantial federal question. Levering & Garrigues v. Morrin, 289 U.S. 103, 105 (1933); Dunton v. County of Suffolk, 729 F.2d at 910.

Furthermore, the issue of whether the attempted waiver of section 19(g) is void is a "question antecedent to [those decided by the Court of Appeals and argued below] and ultimately dispositive of the present dispute." Arcadia, Ohio v. Ohio Power Co., 498 U.S. 73, 77 (1990). Since it goes to the very existence of the contractual provision in question, it must be resolved first, and the resolution should control the outcome of this case. That is especially so because the Federal Arbitration Act does not provide for enforcement of arbitration agreements where there are grounds at law or equity for the revocation of the agreement.

The facts of this case are little different from a hypothetical customer agreement such as, "X Firm shall not be bound by any rule of a self-regulatory organization, except at its election." Such a hypothetical agreement would be contrary to the system of self-regulation on which our securities laws are based, and would be ineffective to the extent it sought to prohibit an SRO from enforcing and complying with its rules. The current case may entail a much lesser invasion of the role of an SRO than such a hypothetical customer agreement, but the relevant legal principles are the same. Thus, at least in the context of the regulated securities industry, the Seventh Circuit errs in its view that "short of authorizing trial by battle or, more doubtfully, by a panel of

three monkeys, parties can stipulate to whatever procedures they want to govern the arbitration of their disputes . . . ." Baravati v. Josephthal, Lyon & Ross, 28 F.3d at 709.

In AALP's view, the federal securities laws play a vital role in our economy, especially in today's climate, where investment is often a necessity and not merely a luxury. See infra, Part II(B)(2). The securities laws should be interpreted liberally to achieve their important purposes, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), and as an Act of Congress, they should prevail over contrary language in a private agreement. Any ambiguity or uncertainty as to whether a private agreement is governed by the federal securities laws should be interpreted in favor of the remedial policies of investor protection that underlie those laws, as well as the policies of regulatory oversight and SRO enforcement.

Consequently, the judgment should be reversed, with directions to remand to the District Court to reinstate the award of punitive damages.



## II. Petitioners' Arbitration Was Governed By The NASD Rules, Not The Customer's Agreement; Even If It Had Been Governed By The Customer's Agreement, No Purported "Waiver" Of Substantive Rights Should Be Enforced When There Is No Waiver Language In The Agreement

Two other threshold issues that have not yet been addressed are: Does the arbitration agreement in the preprinted customer's agreement govern this case at all; and if it does, what have the parties agreed to in that agreement? Those issues are also central to and controlling in this case.

### A. The Customer's Agreement Is Inapposite To This Case

This entire dispute presupposes that petitioners' arbitration was governed by the customer's agreement. However, that is not necessarily so.

Petitioners were not required to invoke the customer's agreement in order to file their complaint in arbitration. Section 12(a) of the NASD Code of Arbitration Procedure requires disputes arising in connection with the business of a member firm to be arbitrated either based on an arbitration agreement, **or** "upon demand of the customer." Section 12(a) of the Code of Arbitration Procedure is very simple; if a customer demands arbitration under the NASD Rules, (s)he gets it. There is no requirement that a customer must invoke a written arbitration agreement.[3]

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[3] The Code of Arbitration Procedure is prescribed and adopted pursuant to Article VII, Section 1(a)(3) of the NASD By-Laws. NASD Code of Arbitration Procedure, § 1.

If petitioners elected arbitration under the "demand of the customer" provision of section 12(a), there should be no New York law clause to invoke, because the customer agreement would be irrelevant to the arbitration. It is not true that submission to New York law is a "general condition" on the petitioners' right to invoke arbitration, compare Mastrobuono, 20 F.3d at 717. Rather, petitioners may invoke arbitration entirely under the NASD Rules.[4]

Based on this, no choice-of-law provision in a customer's agreement can operate to limit a customer's rights that would otherwise be available under the rules of the NASD. The customer can simply choose arbitration under the "demand of the customer" provision in section 12(a), and bypass the customer's agreement.

As an alternative analysis, the customer's agreement itself says that the arbitration shall be conducted "in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc." Section 12(a) of the Code of Arbitration Procedure is one such rule. Moreover, section 42 of the Code of Arbitration Procedure states: "This Code shall be deemed a part of and incorporated by reference in every agreement to arbitrate under the rules of the National Association of Securities Dealers, Inc. including a duly executed Submission Agreement."

As a result, the customer's agreement itself—with the Code of Arbitration Procedure incorporated by reference—invokes an NASD rule that permits the customer

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[4] Similar provisions permitting arbitration at the behest of a public customer exist under the rules of major stock exchanges. See, e.g., New York Stock Exchange, Constitution Art. XI and Rule 600; American Stock Exchange, Constitution Art. VIII, Sec. 1.



to demand arbitration directly, without any reference to or need for the New York choice-of-law provision in that agreement. Using this analysis, the customer's agreement effectively bypasses its own choice-of-law provision by going straight to the NASD Rules, including the "demand of the customer" provision of Section 12(a).

The customer's agreement says the agreement is to be governed by New York law. It does not say the arbitration must be. If the petitioners elected arbitration directly under the "demand of the customer" provision and not the customer's agreement, there would be no cause for New York law to apply. In that event, if state law applied, the remedy would ordinarily be governed by either the law of the forum state or the state having the most significant contacts with the controversy, which in either case is Illinois. Frankel v. Allied Mills, Inc., 369 Ill. 578, 582, 17 N.E.2d 570, 572 (1938) (*lex fori*); Purcell & Wardrope Chartered v. Hertz Corp., 175 Ill.App.3d 1069, 530 N.E.2d 994 (1988) (most significant contacts); see Mastrobuono, 20 F.3d at 715. Nothing in Illinois law prohibits punitive damages in arbitration.

This alone should be dispositive, since a federal court has no jurisdiction to enforce a purported "waiver" under the Federal Arbitration Act, when the parties' arbitration agreement is inapposite to their dispute. If there were any doubt, it should be resolved against respondents, since it was their preprinted customer's agreement that petitioners signed, and all doubts in interpreting a contract should be resolved against the party who drafted it. United States v. Seckinger, 397 U.S. 203, 210 (1970); SOS Oil Corp. v. Norstar Bank of Long Island, 76 N.Y.2d 561, 568, 561 N.Y.S.2d 887, 563 N.E.2d 258, 261 (1990). Since the customer's agreement is irrelevant to this arbitration, there should be no occasion to

impose a punitive damages waiver that can only be argued to emanate from the customer's agreement.

Therefore, the purported waiver of punitive damages in the customer's agreement should not be enforced, because there is no appropriate legal basis on which to enforce it.

B. Federal Courts Should Not Enforce Purported "Waivers" Of Substantive Rights In Arbitration Agreements That Are Based On Inference, And Not The Plain Language Of The Arbitration Agreement

1. There Is Nothing To Suggest Petitioners Intended To Agree To Waive The Right To Punitive Damages, And No Proper Basis For Enforcing Such An Unintended "Waiver"

Even if this Court were to hold that the Customer's Agreement governs here, the question still remains: What have the parties agreed to?

It is noteworthy that the customer's agreement does not say in plain language, "Punitive damages shall not be awarded in any arbitration proceeding." Instead, respondents seek to import this substantial limitation on petitioners' rights through the "back door" of a choice-of-law provision that is claimed to refer to the entire body of New York caselaw, including one case therein which respondents claim "waives" contrary provisions of the rules of the arbitral tribunals specified in the customer's agreement.

A fundamental tenet of interpreting any contract is that a court seeks to effectuate the intent of the parties. Standard Oil Co. of New Jersey v. United States, 340 U.S. 54, 57 (1950); Chesapeake & Ohio Canal Co. v. Hill, 82 U.S.



(15 Wall.) 94, 99-100 (1873). The same is true for an arbitration agreement enforced under federal law, Litton Financial Printing Div. v. NLRB, 501 U.S. 190, 210 (1991); Gateway Coal Co. v. United Mine Workers, 414 U.S. 368, 382 (1974)—an obvious corollary of the fact that an arbitration agreement is a form of contract. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626 (1985). It is true that the parties' intentions are construed in favor of arbitrability, id., but that does not mean they are construed in favor of the waiver of substantive rights.

That a contract is to be interpreted to effectuate the intent of the parties is the law of New York as well. "In the construction of written contracts it is the duty of the court, as near as may be, to place itself in the situation of the parties, and from a consideration of the surrounding circumstances, the occasion and apparent object of the parties, to determine the meaning and intent of the language employed. Indeed, the great object, and practically the only foundation of rules for the construction of contracts, is to arrive at the intention of the parties." Maloney v. Iroquois Brewing Co., 173 N.Y. 303, 310, 66 N.E. 19, 20 (1903).

Here, respondents would have to argue that petitioners intended through such obscure means as these to waive all rights to punitive damages, at the time they signed the customer's agreement. That argument should flunk any test of common sense. One would think that if anything, petitioners intended what the agreement said they were doing—agreeing to arbitration "in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc." Nothing therein would have precluded punitive damages.

Respondents apparently argue that petitioners are charged with having looked past the language of the contract

and even past the language of New York statutes, researched New York caselaw, determined what New York caselaw actually stood for, and thereby made a determination that the right to otherwise available punitive damages was really an illusion. This is not how a contract is formed, and parties cannot be held to waive substantive rights in this manner.

Rather, in order for there to be any waiver by contract, the language of the contract must make it clear that the contracting parties have intended a waiver. This follows directly from the principle that a contract should be interpreted to effectuate the intent of the parties. One need not adopt a "knowing and intelligent" standard for constitutional waiver, Carnley v. Cochran, 369 U.S. 506, 515-516 (1962); but even in a civil contractual context, there must be some element of intentionality to a waiver, and a waiver is still an intentional relinquishment or abandonment of a known right or privilege. Johnson v. Zerbst, 304 U.S. 458, 464 (1938); accord Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378, 1387 (11th Cir. 1988), and cases cited; J. Alexander Securities, Inc v. Mendez, 17 Cal.App.4th 1083, 1093-1094, 21 Cal.Rptr.2d 826, 832 (1993), cert. denied, __ U.S. ___, 114 S.Ct. 2182 (U.S. June 6, 1994).

New York law is particularly strict in this area. Waiver is not only an intentional relinquishment or abandonment of a known right, but there can only be a waiver when there is "both knowledge of [the right's] existence and an intentional to relinquish it." United Commodities-Greece v. Fidelity Int'l Bank, 64 N.Y.2d 449, 457, 489 N.Y.S.2d 31, 34, 478 N.E.2d 172, 175 (1985). Such a waiver is not lightly presumed. Gilbert Frank Corp. v. Federal Ins. Co., 70 N.Y.2d 966, 968, 525 N.Y.S.2d 793, 520 N.E.2d 512, 514 (1988).



These principles militate strongly against any waiver. Since the contract did not say petitioners were waiving their right to punitive damages, and there is nothing anywhere else in the record to suggest they had any intention of relinquishing that right, no waiver should be inferred.

The circumstances of this case, involving a preprinted brokerage house agreement, particularly call out for refusing to enforce a waiver of substantive rights not spelled out in the agreement. In Fuentes v. Shevin, 407 U.S. 67 (1972), this Court refused to give effect to a contractual waiver of the right to a prior hearing for reasons fully applicable here. Most notably, "the contractual language relied upon [did] not, on its face, even amount to a waiver." Id. at 95. And here as in Fuentes, "There was no bargaining over contractual terms between the parties who, in any event, were far from equal in bargaining power. The purported waiver provision was a printed part of a form [brokerage] contract and a necessary condition of the [brokerage]. The [respondents have] made no showing whatever that the [petitioners] were actually aware or made aware of the significance of the [provision] now relied upon as a waiver . . . ." Id. See also infra, p. 27.

The purported waiver of punitive damages here may not involve rights as constitutionally profound as the basic right to notice and a hearing in Fuentes. But the right to punitive damages when provided for by law is a significant and substantial state-law right, and the federal courts are being called upon to deny petitioners any such state-law right. Even if some aspects of Fuentes have been subsequently narrowed by this Court, there is nothing to suggest the analysis above is based on anything other than good law.

But under any circumstances, and Fuentes notwithstanding, "A waiver of a stipulation in an agreement

must, to be effectual, not only be made intentionally, but with knowledge of the circumstances." Bennecke v. Insurance Co., 105 U.S. (15 Otto) 355, 359 (1882); Utley v. Donaldson, 94 U.S. (4 Otto) 29, 49 (1877). There is no such thing as a "stealth waiver." None can be inferred from language which on its face would not suggest to a reasonable contracting party that it is waiving anything.

Furthermore, the mere fact that this issue has split the Circuits (and at least one state court) and is now before this Court is ample evidence that the language of the contract does not clearly and obviously constitute a waiver of the right to punitive damages. If it is not even clear to the courts that this language constitutes a waiver of rights, how could the Mastrobuonos be expected to know this? When they signed their customer's agreement, they were trying to make investments, not argue a case before the United States Supreme Court. They manifested no intent at all, let alone a clear intent, to adopt such an uncertain "waiver."[5]

These are issues that should be reached by this Court. If there is no legal basis for holding petitioners intended to waive their right to punitive damages by signing Shearson's customer agreement, then there is no legal basis for holding that the contractual agreement to arbitrate incorporates such a waiver. A federal court has subject matter jurisdiction to

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[5] Furthermore, a jurisdiction's caselaw is not always completely clear; sometimes, not even a jurisdiction's courts can agree on what its caselaw is. While courts can clarify their law in later decisions, the same standard is not true for contracting parties. Rather, the obligations of a contract are supposed to be definite and certain at the time of the contract. A "contract" that requires the parties to interpret caselaw to figure out what its provisions are can hardly be viewed as a contract, since caselaw can generally be interpreted in more than one way.



enforce an arbitration agreement under 9 U.S.C. § 2—to the extent there *is* an agreement, and only to that extent.

The issue of whether there *is* a contract for the waiver of punitive damages is not only jurisdictional, it is also purely one of law, appropriate for this Court's consideration. Indeed, since this Court would have no jurisdiction to sustain respondents' position if there were no binding contract to waive punitive damages the first place, this too is a "question antecedent to [those decided by the Court of Appeals and argued below] and ultimately dispositive of the present dispute." Arcadia, Ohio v. Ohio Power Co., 498 U.S. at 77.

2. Strong Policy Reasons Militate Against Respondents' Proffered "Waiver By Choice Of Foreign Law Provision"

Beyond these legal considerations, the result sought by respondents would have awful repercussions throughout our illegal system, extending to the conduct of everyday affairs by millions of people in this country.

It is one thing for sophisticated parties voluntarily to hire attorneys to negotiate the best possible contract. It is quite another to say that an ordinary citizen or small business considering a proposed preprinted contract must hire an attorney to do caselaw research to determine what the terms of the proposed contract are. To give the contract the meaning respondents seek would be to hold that the Mastrobuonos had such an obligation.

Indeed, to give the contract the meaning respondents seek could potentially force any ordinary citizen, faced with a preprinted contract such as this one, to hire an attorney if (s)he wants to know the very terms of the contract (s)he is

signing. If a person sees a choice-of-law provision in any contract—be it an auto loan, a mortgage, a tuition assistance agreement, or the like—the person must obtain legal assistance to scour another state's caselaw to figure out what is in the contract. (We are not talking about only selected portions of caselaw; since one can never know where the "hidden traps" are, apparently the only way to discover them is to look everywhere.) In fact, a person contemplating such an contract might be required not only to hire an attorney, but to hire an attorney from another jurisdiction.

This is an absolutely atrocious result. It is a potentially staggering burden on everyday commerce by ordinary citizens and small businesses. Those who do not wish to shoulder the burden are put at risk of "waivers" they would never have reason to anticipate. The result could even operate as a trap for the unwary by encouraging larger businesses to put hidden "choice-of-law" waivers into preprinted agreements, intentionally.

An enormous amount of modern commerce is handled through preprinted agreements required by large businesses. There is no way an average person or small business can hire an attorney at every turn to try to figure out what the terms of each one of those agreements are supposed to be. And as a result, people will operate in complete uncertainty of what they are agreeing to, every time they sign an agreement with a choice-of-law provision.

AALP is especially disturbed by the possibility of such a result because of its grave ramifications for investors.

Investment through a brokerage firm, or another entity that might insist on a preprinted arbitration clause, is no longer just a luxury for the rich. It is an absolute necessity for



millions of people of much lesser means, including people who are just trying to save some money for retirement through a mutual fund, or seeking other means for growth of modest assets—perhaps merely to keep up with inflation. Arbitration agreements are everywhere, and a person may have absolutely no choice but to sign one if (s)he wants to invest any amount of money anywhere, beyond putting it in the bank at 2-3 percent. "The average investor would be hard put to find a brokerage that would accept his/her business without a prior arbitration agreement." In re Arbitration Between Dreyfus Service Corp. and Kent, 183 A.D.2d 446, 448, 584 N.Y.S.2d 483, 485 (1992) (Asch, J., concurring).[6]

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[6] This was the very reason why one judge of the Appellate Division, in a recent case, suggested that the rule of Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976) might be ripe for reexamination in light of changing times and circumstances:

> The four person majority in Garrity (supra, at 359) wrote, in pertinent part:
>
> "Parties to arbitration agree to the substitution of a private tribunal for purposes of deciding their disputes without the expense, delay and rigidities of traditional courts. If arbitrators were allowed to impose punitive damages, the usefulness of arbitration would be destroyed. It would become a trap for the unwary given the eminently desirable freedom from judicial overview of law and facts. It would mean that the scope of determination by arbitrators, by the license to award punitive damages, would be both unpredictable and uncontrollable. It would lead to a Shylock principle of doing business without a Portia-like escape from the vise of a logic foreign to arbitration law.

(continued...)

[6](...continued)

"In imposing penal sanctions in private arrangements, a tradition of the rule of law in organized society is violated. One purpose of the rule of law is to require that the use of coercion be controlled by the State [citation]. In a highly developed commercial and economic society the use of private force is not the danger, but the uncontrolled use of coercive economic sanctions in private arrangements." . . .

Note, even in Garrity (supra, at 359), the Court explicitly recognized that: "In a highly developed commercial and economic society the use of private force is not the danger, but the uncontrolled use of coercive economic sanctions in private arrangements."

That is my precise concern with the present rule. It appears that the present state of affairs, at least in the securities field, where consent to arbitration of disputes is now a sine qua non before the average citizen can open an account at any brokerage, has reversed the application of these principles enunciated by the Court of Appeals. Before the United States Supreme Court decided that an arbitration agreement in an investor-broker contract was binding on the investor (see, Shearson/American Express v McMahon, 482 US 220), the investor could proceed in arbitration and waive any claim to punitive damages or bring suit in a judicial forum where such a claim would be cognizable. Since McMahon, this option has been largely foreclosed. The average investor would be hard put to find a brokerage that would accept his/her business without a prior arbitration agreement. Accordingly, arbitration has now become "a trap for the unwary" investor. Under the present state of affairs, the danger represented in "the uncontrolled use of coercive economic sanctions in private arrangements" (supra, at 359) no longer refers to the ability of an arbitrator to

(continued...)



Still, arbitration is not of itself perceived as unfair to investors—so long as the premise of Shearson v. McMahon that no substantive rights are sacrificed in arbitration is satisfied, and so long as customers are not later surprised by "waivers" that appear nowhere in the preprinted arbitration agreements they are obligated to execute. But when those pillars fall down, so does the system of arbitration and investor protection they support. The proper solution is not to require every prospective investor to have an expensive out-of-state lawyer at hand, ready to scour out-of-state caselaw to figure out what the investor is agreeing to—or, in the alternative, expect that investors must suffer unstated "hidden traps" as the price they must pay for trying to stash away a few dollars for their retirement.

Permitting such a system of "hidden traps" also encourages serious overreaching by brokerage houses. In a case similar to this one, the brokerage house strenuously argued that "the **sole reason** for incorporating a New York law provision was to preclude punitive damages awards." J. Alexander Securities, Inc. v. Mendez, 17 Cal.App.4th 1083, 1093 n.9, 21 Cal.Rptr.2d 826, 832 n.9 (1993) (emphasis added), cert. denied, ___ U.S. ___, 114 S.Ct. 2182 (U.S. June 6, 1994). Since the brokerage house knew it was trying to effect a waiver, it could have just put plain language in its preprinted agreement: "No punitive damage awards are permitted in an arbitration arising out of the customer's

[6](...continued)

impose punitive damages, but the inability of the investor to recover for real, and in some cases, glaring abuses.

In re Arbitration Between Dreyfus Service Corp. and Kent, 183 A.D.2d 446, 448, 584 N.Y.S.2d 483, 484-85 (1992) (Asch, J., concurring).

accounts." Instead, the brokerage house chose the "hidden trap" method, by burying the attempted waiver within a choice-of-law provision. Id., 17 Cal.App.4th at 1093 n.9, 21 Cal.Rptr.2d at 832 n.9. Federal courts need not and should not enforce the Federal Arbitration Act in a way that tolerates and encourages such intentional overreaching, especially given the much broader consequences discussed herein.

There are further special concerns with preprinted brokerage house arbitration agreements. Such agreements are often valueless to customers, because even if there is no written agreement, the NASD and major stock exchanges all have provisions requiring member firms and associated persons to arbitrate customer disputes if the customer so elects. NASD Code of Arbitration, Sec. 12(a); New York Stock Exchange, Const. Art. XI and Rule 600; American Stock Exchange Const., Art. VIII, sec. 1.[7] In other words, without the arbitration agreement, the customer would still have the same right to arbitrate with a choice of arbitral tribunals.

Thus, often it is only the brokerage house that gains from a preprinted arbitration agreement. That would have been true in the Mastrobuonos' case as well, since Shearson is a member of all major exchanges and the NASD, and petitioners could have demanded arbitration before any of those bodies with or without an arbitration agreement.

Perhaps such a one-sided "agreement" is now thought to be the price a person must pay for putting money somewhere other than in a bank. But that does not mean a

---

[7] The rules of the major exchanges are similar to the NASD rules and serve the same functions in arbitration. Dean Witter Reynolds, Inc. v. McCoy, 995 F.2d 649, 651 (6th Cir. 1993).



federal court should go beyond the agreement to arbitrate, and read into the customer's agreement a waiver of substantial rights that is not clearly and specifically spelled out therein.

In fact, quite the opposite is true, even without reference to the fact that the purported "waiver" is not based on any language in the contract. Under the principles of D.H. Overmyer Co. v. Frick Co., 405 U.S. 174, 187 (1972), a contractual waiver should not be enforced if it is a contract of adhesion, there is great disparity in the parties' respective bargaining power, and there is no consideration for the waiver. Accord L.K. Comstock & Co. v. New York Convention Center Dev't Corp., 179 A.D.2d 322, 329, 584 N.Y.S.2d 472, 478 (1992).

Those are exactly the facts of this case. While absence of consideration for a contractual waiver may be unusual, it is the situation here, because respondents' arbitration clause—the vehicle by which respondents are claiming a waiver of the right to punitive damages—gained petitioners nothing they did not have anyway under the NASD, New York Stock Exchange, and American Stock Exchange rules. As a result, the sought-after waiver of the right to punitive damages stemming directly from the arbitration clause in the Customer's Agreement should be unenforceable under an Overmyer analysis as well.

3. Conclusion To Part II(B)

All of these principles are especially applicable in a federal court. When a federal court is asked to interpret the Federal Arbitration Act, it must apply federal common law, since 9 U.S.C. § 2 "create[s] a body of substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act." Moses H. Cone Memorial Hospital

v. Mercury Construction Corp., 460 U.S. 1, 25 (1983). And under federal law, a person is not held to have waived a substantive right unless (s)he knows (s)he is doing so.

This law should govern any invocation of the Federal Arbitration Act as well. The claimed "waiver" should be held not to exist, and should not be enforced by the federal courts.

If any doubts remained, they should be resolved in favor of the arbitrators' award. Indeed, it is arguable that the award should be respected now, and the District Court did not have subject matter jurisdiction to vacate the punitive damages portion. Once a dispute is held arbitrable, questions of procedure and law are for the arbitrators, especially under broad arbitration provisions such as section 12 of the NASD Code of Arbitration. Any ambiguity is resolved in favor of arbitration. Volt Information Sciences, Inc. v. Board of Trustees of Stanford University, 489 U.S. 468, 485-86 (1989). Here, the arbitrators considered respondents' claims, and ruled that punitive damages were awardable. Even if that were legally erroneous, legal error is not a ground in 9 U.S.C. § 10 for vacating an arbitration award.

In any event, based on the principles in this section, petitioners should not be held to have waived their right to punitive damages based on the choice-of-law provision in the Customer's Agreement.



## CONCLUSION

For these reasons, as well as those set forth by the petitioners, AALP joins the petitioners in asking that the judgment of the Court of Appeals be reversed.

Dated this 14th day of November, 1994.

Respectfully submitted,

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No. 94-18

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1994

Antonio C. Mastrobuono and
Diana G. Mastrobuono,

*Petitioners,*

v.

Shearson Lehman Hutton Inc.,
a corporation,
Nick DiMinico, Richard F. Benzer,
and Mark Stevenson,

*Respondents.*

## Motion for Leave to File Brief Amicus Curiae and Brief Amicus Curiae in Support of Petitioners

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## MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE

The Public Investors Arbitration Bar Association hereby respectfully moves for leave to file the attached brief amicus curiae in this case. The consent of the attorney for the Petitioners has been

obtained. The consent of the attorney for the Respondents was requested but refused.

The interest of the Public Investors Arbitration Bar Association in this case arises from the fact that its members currently represent public investors involved in securities arbitrations and related litigation actions pending before arbitration panels and state and federal courts throughout the United States, in which the same issue is before the Court, namely whether securities arbitration panels have the power to award punitive damages.

In the instant case in the Court of Appeals, Petitioners barely mentioned the public policy implications of the ability of arbitrators to award punitive damages, and also barely dealt with the issue of whether the agreement between the parties invoked the rule of New York law that prohibits arbitrators from awarding punitive damages.



Since it is likely that Petitioners may pursue the same course in this court, it is believed that the brief which amicus curiae is requesting permission to file will contain a more complete argument on the public policy issues and the invocation of the New York rule. If this argument is accepted, it could be dispositive of this case.

Respectfully submitted,

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## Interest of Amicus Curiae

It is the avowed purpose of the Public Investors Arbitration Bar Association ("PIABA") to create within the securities arbitration process what has been referred to as a "level playing field." PIABA is composed of attorneys from most of the 50 states who concentrate a significant majority of their practice in the representation of public investors throughout the 50 states. Members of PIABA have encountered the issue that is before this court in many arbitration and litigation proceedings throughout most of the 50 states and in many state and federal courts throughout the country.

## Summary of Argument

The Public Investors Arbitration Bar Association, as amicus curiae, urges this Court to reverse the decision of the court of appeals because punitive damages play an

important role in securities arbitration.[1]

The lower court, in its decision, failed to appreciate this important role. The decision below was based upon two conclusions:

(1) that New York law, viz. Garrity v. Lyle Stuart Inc., 40 N.Y.2d 354 (1976), impermissibly prohibits arbitrators from awarding punitive damages; and

(2) that the agreement between the parties must be read to invoke the rule of Garrity.

Each of these two conclusions, however, is built on a faulty foundation, and, for the reasons herein stated, as well as those

[1] PIABA is composed of attorneys that represent public investors in securities arbitration and related litigation actions in most of the 50 states and state and federal courts. The issue of whether arbitrators have the power to award punitive damages arises frequently in these proceedings.



stated by Appellant in its Brief, the decision below was in error and should be reversed.

## POINT I: NEW YORK'S GARRITY RULE IS AN UNWISE AND ANACHRONISTIC INTRUSION INTO THE PROVINCE OF THE ARBITRATOR, AND IS A HOLDOVER FROM AN ERA WHEN ARBITRATION WAS SUSPECT

New York law, which ousts arbitrators of any authority to award punitive damages, is contrary to the principles that underlie the Federal Arbitration Act. See generally Southland Corp. v. Keating, 465 U.S. 1, 16 (1984) ("Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements"). See also Moses H. Cone Memorial Hospital v. Mercury Construction Corp., 460 U.S. 1, 25, n.32 (1983); Volt Information Sciences v. Board of Trustees for the Leland Stanford Jr. University, 489 U.S. 468 (1989).

Garrity v. Lyle Stuart, Inc., supra., upon which "New York law" and the decision below rests, was decided in 1976. Since

that time, arbitration has gained widespread acceptance as a fair, useful and sound method of dispute resolution. Indeed, this Court, which at one time displayed a hostility to arbitration similar to that of the Garrity Court, now views nearly all arbitration agreements as valid and enforceable.[2]

The arbitrators in Garrity had awarded the arbitration claimant $45,000 in compensatory damages and $7,500 in punitive damages after the arbitration respondent had walked out of the hearing dissatisfied with the certain preliminary rulings. The New York Supreme Court confirmed the award, and that decision was affirmed by the Appellate

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[2]In fact, this Court once viewed pre-dispute arbitration agreements in securities fraud cases as unenforceable, see Wilko v. Swann, 346 U.S. 427 (1953), but that position has changed markedly in recent years. See Rodriguez de Queijas v. Shearson/American Express, Inc., 109 S.Ct. 1917 (1989); Shearson/American Express Inc. v. McMahon, 482 U.S. 220, rehearing denied, 483 U.S. 1056 (1987).



Division. The respondent, however, persisted in its appeal to New York's highest court, challenging only the punitive damage portion of the award. The Court of Appeals split 4-3, vacating the punitive damage award and rendering New York arbitrators powerless to award punitive damages.

Joan Garrity, the claimant in the arbitration, was the author of two successful books, and she alleged that the respondent, the books' publisher, had "maliciously" withheld royalty payments due her. The Court of Appeals, in ordering modification of the award, stated:

> An arbitrator has no power to award punitive damages, even if agreed upon by the parties. [citation omitted] Punitive damages is a sanction reserved to the State, a public policy of such magnitude as to call for judicial intrusion to prevent its contravention.

Garrity, 40 N.Y. 2d at 356. It is submitted that New York's policy in this regard is

antithetical to the federal policies encouraging the arbitrability of disputes.

The New York Court of Appeals expressed several motivations for its decision, all grouped under the general heading of "public policy." The court was obviously concerned that the free reign given to arbitral authority by the legislature and the courts might lead to punitive awards that are excessive and beyond the reach of the courts to correct.

This fear was underscored by the nature of the substantive claims involved in Garrity, i.e. breach of contract. It is of course well-established that punitive damages are not, as a matter of law, available in an action for breach of contract, no matter how willful or wanton the breach. Garrity, 40 N.Y. 2d at 358. Yet, as the Court observed in Garrity, arbitrators are not bound by such substantive legal provisions, and the courts



are not permitted to overturn an award based upon an error in applying substantive legal principles. Denying arbitrators the power to apply punitive damages was a logical way to correct the arbitrator's legal error.

But Judge Gabrielli, along with Judge Wachtler and Jones, dissented from the now-controversial ruling in Garrity. The dissenters criticized the majority for vacating a "rational and just award," 40 N.Y.2d at 360, thus suggesting that an irrational or unjust award could be vacated by the Court.

The majority decision in Garrity, however, goes beyond mere concern over the misapplication of substantive law. Rather, the Court's opinion bespeaks a blatant suspicion of the arbitral process, one that is difficult to reconcile with the strong current policies favoring arbitration.

Judged by the standards in effect seventeen years ago, the Garrity Court's

suspicion of arbitration was not inconsistent with the limited experience society had with commercial arbitration at the time. As stated, the Court's decision was also consistent with some of the then-existing federal misgivings about arbitration.

But the climate of distrust that gave rise to the federal decision in Wilko in the 1950's, and the New York decision in Garrity in the 1970's, no longer exists in the 1990's. It is thus not surprising that in virtually every forum outside New York, judicial hostility to Garrity has been overwhelming. Judges sitting in the federal courts located outside New York state have almost always seen fit to ignore it, sidestep it, or simply reject it out of hand, even in cases where the arbitration agreement involved contained a New York choice of law clause. See e.g., Raytheon Co. v. Automated Business Systems, Inc., 882



F2d 6 (1st Cir. 1989)(Reinhardt, J.); Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378 (11th Cir. 1988)(Kravitch, J.) Todd Shipyards v. Christensen, 943 F2d 1056 (9th Cir 1991).[3] Likewise, other state courts have with almost amazing uniformity refused to apply New York's limitation on punitive damages in arbitration.[4]

Importantly, virtually all courts now view the arbitration system differently from the way it was viewed in Garrity. As one court has stated on the issue of an

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[3] See also Willis v. Shearson/American Express, Inc., 569 F. Supp. 821 (M.D.N.C. 1983) (H.Ward, J.)(holding that, even though the contract contained a New York choice-of-law clause, federal law favoring arbitrability supersedes the Garrity rule).

[4] See, e.g. Baker v. Sadick, 208 Cal.Rep. (1984); State Farm Fire & Casualty Co. v. Wise, 721 p.2d 674 (Ariz.App. 1986).
In addition, nearly all scholarly commentators have been critical of Garrity. See, e.g. Stipanovich, Punitive Damages in Arbitration - Garrity v. Lyle Stuart Revisited, 66 B.U.L. Rev. 953 (1986).

arbitrator's power to award punitive damages:

> [A]n arbitrator steeped in the practice of a given trade is often better equipped than a judge... to decide what behavior so transgresses the limits of acceptable commercial practice in that trade as to warrant a punitive award...

Willoughby Roofing and Supply Inc., v. Kajima International, Inc., 598 F.Supp. 353 (N.D. Ala. 1984), affirmed, 776 F.2d 269 (11th Cir. 1985).

More recently, the 1st Circuit, in Raytheon, supra, expressed the prevailing view:

> Punitive damages serve as an effective deterrent to malicious or fraudulent conduct. Where such conduct could give rise to punitive damages if proved in court, there is no compelling reason to prohibit a party which proves the same conduct to a panel of arbitrators from recovering the same damages.

Raytheon, at 10.



Indeed, even in New York, the Garrity rule has been criticized in the context of securities arbitration. In Matter of Dreyfus Service Corp. v. Kent, 183 A.D.2d 446, 584 N.Y.S2d 483 (1st Dep't.), Motion for Leave for Appeal Denied, 81N.Y. 2d 701, 594, N.Y.S. 2d 715, 610 N.E.2d 388, 1992, an intermediate level appellate court dutifully followed Garrity. But, in a separate concurring opinion, Justice Sidney Asch Wrote:

> if the Court of Appeals were to reexamine the issue of whether punitive damages can be awarded by an arbitrator in a securities dispute, it might well decide that changing times and circumstances mandate a reconsideration of the rule announced in Garrity....
>
> Under the present state of affairs, the danger represented in 'the uncontrolled use of coercive economic sanctions in private agreements' no longer refers to the ability of an arbitrator to impose punitive damages, but the inability of the investor to recover for real, and in some cases, glaring abuses.

N.Y.S. 2d at 484-485[5]

Garrity, of course, did not involve securities fraud, and it can be distinguished from the instant matter based upon that fact. Indeed, the differences between ordinary commercial arbitration based on breach of contract and securities arbitration based, for the most part, on fraud, presents important grounds for not applying Garrity to securities arbitration.

Punitive damages play a necessary and important role in securities arbitration. When awarded at the conclusion of a matter,

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[5] Like the case at bar, the Kent arbitration involved a dispute over fraud and misrepresentation in the sale of securities. The arbitrator who heard the dispute considered the evidence, and determined that a case had been made for punitive damages. No claim was made that the arbitrator's award was irrational, without merit or that it was excessive. Rather, Dreyfus only claimed, and the Appellate Division determined, that Garrity's precedential force mandates vacatur of the arbitrator's award insofar as punitive damages are concerned. The New York Court of Appeals denied the motion for leave to appeal.



punitive damages serve as a deterrent to similar unlawful conduct. And at the outset of a case, the prospect that punitive damages might be awarded can motivate a transgressor promptly to offer adequate compensation or a fair settlement for the wrong that has been committed.

The rule of Garrity should not be applied to securities arbitration because punitive damages are necessary to police adequately the securities industry, where deterrence of wrongful conduct and the benefits of early settlement are especially important. The securities industry is involved in the sensitive fiduciary task of giving financial advice and investing other people's money on a commission basis. If a brokerage firm is assessed punitive damages for knowingly fraudulent or grossly negligent behavior, the firm is likely to cease and desist from such offensive conduct. Conversely, if the securities

industry is insulated from the dangers of punitive damages, (as it is under Garrity), there will be far less deterrence, and, consequently, a greater number of abuses.

Miley v. Oppenheimer & Co., 637 F.2d 318, 330 (5th Cir. 1981), was one of the first appellate cases upholding a jury verdict of punitive damages against a securities firm. As the Fifth Circuit explained in Miley, relying in part on the work of one of the authors of this brief;

> Most courts in the past have seen fit, when they find the broker-dealer's hand in the till, to simply request removal of the offending appendage. And when the till is empty, and the broker-dealer's fingerprints are all that remain where the money once lay, all the courts do is to require the crook to replace the booty. If ever there was a situation where crime pays it is in such circumstances;...No wonder one commentator saw fit to term the average recovery in churning cases as creating for the broker-dealer a "low risk larceny."
> ...[T]he only sure way of deterring such conduct in the future is to take the profit away from the wrongdoers and slap on an additional amount as punitive damages;...
>
> Goldberg, Fraudulent [Broker]-Dealer Practices, sec.6.5 (1978).

Miley, 637 F.2d at 331-32.



Logic similar to that used by the Fifth Circuit in Miley has been used time and again by other courts reviewing punitive damage assessments against brokerage firms. See, e.g., Raytheon, supra. In the post-McMahon era, even though juries have been preempted from considering punitive damage verdicts against securities firms because such cases are now heard in arbitration, the force of Miley, that punitive damages provide much-needed deterrence, is still very much appropriate. If the type of deterrence that motivated the Miley court is to be achieved in the post-McMahon era, the rule of Garrity must not be extended to securities arbitration.

A vivid example of the deterrent effect that punitive damage awards can have on the securities industry took place in the summer of 1988. During that summer, arbitrators in

two separate arbitrations awarded investors a total of over $2.5 million in punitive damages against Dean Witter Reynolds, Inc. See Matter of Mark & Traczyk v. Dean Witter Reynolds, Inc. (AAA Fla. 7/29/88) and Matter of Hutcheson v. Dean Witter Reynolds, Inc., (AAA Fla. 8/12/88) summarized in Goldberg, 1991 REPORT OF THE PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION AS TO THE AUTHORITY OF ARBITRATORS TO AWARD PUNITIVE DAMAGES IN SECURITIES ARBITRATION (1991), at 18-21. Both these arbitrations were decided by panels of the American Arbitration Association sitting in Florida. Both matters focused on the unsuitability of naked index options in the accounts of an elderly couple (Mark & Traczyk) and a recently widowed housewife (Hutcheson).

Just six days after the second award, Haskell T. Adler, southern regional manager for Dean Witter, issued a memo dated August 18, 1988 to "Florida Regional Managers" on



the topic "Florida Regional Options Policy."

The memo stated:

> Effective immediately, the only types of options activity that will be permitted in the Florida Region will be the following:
>
> 1. The selling (writing) of covered equity calls. To be considered covered the equities underlying the calls must be on deposit in the account or be purchased at the same time the calls are sold, or they must be backed by escrow receipts in approved accounts.
>
> 2. The selling (writing) of cash secured equity puts. In this case there must be on deposit in the account a cash amount equal to the value of the strike price of the put sold.
>
> Example: Client sells 1 XYZ August 40 put.
>
> Strike price of put $40
> X 100 = $4,000
> requirement.
>
> Any account engaged in this type of activity must be interviewed by the branch manager and a memo regarding the account's suitability to engage in the selling (writing) of cash secured equity puts must accompany the Option Client Information form which is to be sent to the Regional Director for final approval.

3. The purchase of Put or Call Index Options.

4. The purchase of Put or Call Equity Options.

Any account executive who violates this policy will be subject to disciplinary action up to and including termination.

The deterrent effect of the punitive damage awards is obvious. The activity prohibited by the Adler memo is precisely the activity involved in the two arbitrations. With the advent of the Dean Witter prohibition and screening process, elderly and unsophisticated investors are far less likely to be harmed by similar practices at Dean Witter. Without the punitive damage awards, the practice might well have continued, causing untold losses to other innocent investors.

Punitive damages thus play a crucial role in policing the securities industry. The ever-contracting budgets of governmental watchdogs makes public policing alone impractical and far too sporadic. But



public investors, acting as private attorneys-general, can play a useful part in deterring securities fraud. If the rule of Garrity is retained in securities arbitration, such non-governmental policing will cease to exist, and investors will be less safe from those who might wantonly or willfully like to part them from their money.

The importance of deterrence notwithstanding, the members of the Public Investors Arbitration Bar Association are especially concerned with the important role punitive damages play in the settlement of disputes. Our collective experience is that in many situations, it is impossible to reach an expeditious and just settlement in cases where punitive damages are not available. And unfortunately, securities arbitration cases frequently involve elderly customers who have lost all or a substantial

part of their life's savings.[6] In such cases, expeditious and just settlement is especially important.

If arbitrators are not empowered to award punitive damages, brokerage firms have minimal incentive adequately to settle just disputes. If Garrity is extended to securities arbitrations, brokerage firms will know in advance that the worst they can do in arbitration is to be forced to make restitution; their incentive to make that restitution prior to hearing and award will be all but eliminated. Instead, brokerage firms often offer settlements that are smaller than the amount justly deserved, knowing that the investor must then face the difficult choice of (1) taking the lesser sum, or (2) incurring significant attorneys

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[6] An example of this is the NASD arbitration case of Peterson v. Shearson (NASD - AZ '89) which resulted in a punitive damage award of $1,000,000 which was paid in full. The arbitrator's case summary began with the following sentence: "Peterson is a 100 year old widow with impaired vision."



fees, expert witness fees and arbitral forum fees in order to obtain restitution (less the costs of the proceeding).[7]

The possibility of punitive damage awards reduces the likelihood that brokerage firms will commit "extortion by arbitration." The prospect of punitive damages awards has a useful impact on dispute control and the encouragement of just settlements, and punitive damages should not be eliminated through the insertion of an innocent-looking choice-of-law clause into a consumer contract of adhesion.

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[7] The prospect of this type of conduct occurring in the setting of litigation is reduced not only by the availability of punitive damages, but also by the possibility of the imposition of sanctions by the court. In this regard, it is worth noting that arbitrators lack the power to "sanction" participants for misbehavior or for making legal and factual arguments that are frivolous, baseless and without any merit. See, e.g. A.G. Edwards & Sons v. McCollough. No. M90-129-PHX-PGR, slip op., (D.Ariz. May 2, 1991)(Rosenblatt, J.)

The need for punitive damages in securities cases is best summed up by recounting a statement made in Aldrich v. Thomson, McKinnon Securities, Inc., 746 F.2d 243, 246 n.3 (2d Cir. 1985)(Lumbard, J.).

> Thomson McKinnon's wanton and reckless disregard of the trust placed in it by Aldrich was not only a wrong against her but, by what it portended for other unfortunate investors, it was a wrong against the general public. Thomson McKinnon, a seller of securities on national exchanges and over the counter, a member of the New York Stock Exchange and other leading exchanges, is a large, highly regulated, and socially significant institution. ...[T]he purpose of the punitive damage award is to punish and deter the offender...[and to] discourage repetition of Thomson McKinnon's grossly negligent conduct, or instances of such conduct by other brokerage firms.



Id. at 249.[8] The deterrent effect just-described would be lost if the rule of Garrity is permitted to operate nationally in the context of securities arbitration.

## POINT II: IT IS UNCONSCIONABLE TO ALLOW THE SECURITIES INDUSTRY TO USE THE NEW YORK CHOICE OF LAW CLAUSE IN ITS CONTRACTS OF ADHESION TO INSULATE ITSELF FROM PUNITIVE DAMAGE AWARDS

The members of the securities industry almost uniformly require that customers sign a pre-printed "Customer Agreement." The Appellant here was such a customer. The standard "Customer Agreement," like the agreement in the case at bar, invariably has two clauses of significance. The first calls for arbitration, typically before one or more industry self-regulatory

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[8] While the approach of Garrity has been followed in Indiana, School City of East Chicago, Indiana v. East Chicago Federation of Teachers, 422 N.E.2d 656 (Ind.App. 1981)(Gerrard, J.), West Virginia, Anderson v. Nichols, 359 S.E.2d 117, 121, n.1 (W.Va. 1987)(Nealy, J.), and New Mexico, Shaw v. Kuhnel & Associates Inc., 698 p.2d 880, 882 (1985)(Riordan, J.), none of these cases involved securities arbitration.

organizations; the second states that New York law shall govern any controversy. These two clauses then work together (in a somewhat surreptitious way) to insulate the industry from effective policing by private attorneys general. This Court should not sanction such a practice.

In Garrity, the New York Court of Appeals expressed a concern about permitting arbitrators to award punitive damages because their selection can be "restricted or manipulat[ed] by the party in a superior bargaining position." This fear, however, has no application to investor-initiated securities arbitration, because, almost invariably, when punitive damages are awarded in connection with claims brought by public investors, the punitive damages are awarded to the investors against the brokerage firms.

Needless to say, in securities arbitration, it is the brokerage industry



that holds the superior bargaining position, and it was the brokerage industry that was the driving force behind compulsory arbitration of securities disputes. On June 8, 1987, when the United States Supreme Court reversed its thirty-four year tradition of federal judicial hostility toward arbitration of securities disputes, and held that an arbitration agreement in an investor-broker contract was binding on the investor, the appeal was brought by a securities firm, and the Securities Industry Association supported that position by filing a brief as Amicus Curiae. See Shearson/American Express Inc. v. McMahon, 482 U.S. 220, rehearing denied, 483 U.S. 1056 (1987).

In most cases, the arbitration agreements in broker-customer agreements permit arbitration only before the various self-regulatory organizations of which the firm is a member. The arbitrations thus

take place in the brokerage firm's proverbial backyard, where the customer can exert little influence and there is scant chance for the evil manipulation to occur. Even in the (rare) case where securities arbitration is not before a self-regulatory organization, it takes place before the American Arbitration Association, which boasts a long history of impartial resolution of disputes.[9]

In short, the "evil manipulation" rationale for Garrity cannot logically be applied to securities arbitration in the 1990s. Thus, while Garrity might still have validity in some contexts, it simply should not be applied to securities arbitrations, especially those conducted in states that permit arbitrators to award punitive damages.

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[9] And as added insurance against manipulation, most securities arbitrations, whether held before the SROs or the AAA, have a member or affiliate of the brokerage industry on the panel.



Yet another underpinning of the rule of Garrity is that arbitration should not be permitted to replace the State as the "engine for imposing a judicial sanction." But the securities industry, through its dogged advocacy of arbitration as the exclusive mechanism for the adjudication of public investor grievances, has left the State judiciary no role in the process of resolving broker-customer disputes. See Shearson v. McMahon. supra. It is also noteworthy that in McMahon, the Supreme Court specifically took from the courts, and gave to arbitrators, the power to determine R.I.C.O. claims in public investor disputes, including claims for treble damages under that statute.

That same industry now urges that Garrity be exported to include securities arbitration awards in states that decline to follow the rule. In so doing, the industry seeks to insulate itself from effective

punishment. Having succeeded completely in replacing the State and Federal judiciary as the "engine" for the adjudication of customer disputes, the securities industry now employs Garrity to prevent awards of punitive damages against themselves.

The use of Garrity, within the monopolistic area of securities arbitration, is less than ethical because it constitutes an indirect way of violating rule 21(f)(4) of the N.A.S.D.'s Rules of Fair Practice, which mandates that: "No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." Thus, while no brokerage firm could write a pre-dispute arbitration clause that directly states that "no customer can obtain punitive damages in securities arbitration," that same result is



achieved through the indirect device of putting a New York choice-of-law clause into a national securities contract which then seeks to govern millions of public investors who have no other contact with the state of New York other than the aforesaid clause in their brokerage contracts. In addition, efforts by such self-regulatory organizations as the NYSE to include a punitive damages section in their standard arbitration award form are rendered a nullity by the express reference to New York law (and implicit invocation of Garrity) in the standard brokerage contract.

Today, the members of that same industry, armed with a monopoly over adjudication of customer disputes, seek to utilize the agreements they have extracted from their customers to insulate themselves from punishment for such torts as breach of fiduciary duty and the most invidious kinds of frauds. Now that the United States

Supreme Court has virtually foreclosed the possibility of litigation of broker-customer disputes, arbitration must assume the role of judge, jury and policemen in resolving claims against the brokerage industry.

To compound matters, it must be noted that the securities industry knows that the laws of states other than New York permit punitive damage awards by arbitrators. For this reason, many members of the industry actively seek to impose the New York view on non-New York claimants by placing New York governing law provisions in their standard form contracts they make their customers sign.[10] Clearly, the inclusion of such a provision is intended to extend the rule of Garrity across the nation. By imposing Garrity on the perhaps-unwilling, out-of-

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[10] On the other hand, customers of brokerage firms know nothing about the rule of Garrity, and they are thus likely to be surprised when they learn that New York's Garrity rule forecloses any award of punitive damages.



state participants in the securities arbitration process, New York law becomes the shield that the securities industry uses against claims of securities fraud.[11] And by designating New York law as governing, (often adding language "without giving effect to New York's conflict-of-laws provisions,") they seek to disenfranchise the judiciary of other states and the consumer protection laws of those states (regardless of the anti-waiver provisions contained therein), and compel application of Garrity even in states that reject it.

This Court should decline to participate in this disenfranchisement. Members of the securities industry know that a provision in their contracts which would expressly provide that a state's consumer

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[11] Indeed, to the extent that other jurisdictions, with or without a New York choice-of-law clause, have declined to adhere to Garrity, New York's Garrity rule becomes the source of conflict with the law of other jurisdictions.

protection laws would not govern the transaction would be void if that state's law contained an anti-waiver provision. The securities industry instead inserts a New York choice-of-law clause in their agreements and makes the same otherwise prohibited argument that the remedy of punitive damages has been waived by the investor.

This Court should reverse the decision below because it is unconscionable to permit the New York choice-of-law clause, contained in a consumer contract of adhesion, to insulate the securities industry from the deterrent effect of punitive damage awards.



## Conclusion

For the reasons stated here, the Public Investors Arbitration Bar Association, as amicus curiae, urges this Court to reverse the decision of the court of appeals.

Respectfully submitted,

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No. 94-18

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# In the Supreme Court of the United States

OCTOBER TERM, 1994

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ANTONIO C. MASTROBUONO, ET AL.,

PETITIONERS,

v.

SHEARSON LEHMAN HUTTON, INC., ET AL.,

RESPONDENTS.

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**On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit**

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## BRIEF FOR THE SECURITIES INDUSTRY ASSOCIATION AS AMICUS CURIAE SUPPORTING RESPONDENTS

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## QUESTION PRESENTED

Whether the contract between petitioners and respondent Shearson Lehman Hutton precluded the arbitrators from awarding punitive damages.

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# In the Supreme Court of the United States

OCTOBER TERM, 1994

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No. 94-18

ANTONIO C. MASTROBUONO, ET AL.,

PETITIONERS,

v.

SHEARSON LEHMAN HUTTON, INC., ET AL.,

RESPONDENTS.

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**On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit**

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## BRIEF FOR THE SECURITIES INDUSTRY ASSOCIATION AS AMICUS CURIAE SUPPORTING RESPONDENTS

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## INTEREST OF THE AMICUS CURIAE

The Securities Industry Association (SIA) is the principal trade association of the securities industry, with more than 750 member firms in the United States and Canada. As a member of the Securities Industry Conference on Arbitration, the SIA has been intimately involved in the evolution of the

arbitration process. That process began in the securities industry as far back as 1872, when the New York Stock Exchange began using alternate means of resolving disputes. From the time of that rudimentary beginning to today's substantial arbitration system, which disposes of more than five thousand claims annually, the securities industry has been a pioneer in the use of arbitration to resolve disputes quickly, fairly, efficiently, and economically.

This case brings before the Court an important question about arbitration. The arbitration agreements between securities firms and their customers frequently contain a choice-of-law clause; different agreements reference the laws of different States. The industry contends, and numerous courts — including the courts below — have agreed, that clauses referencing New York law incorporate into the agreement the rule of *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976), which held that arbitrators may not award punitive damages. Petitioners argue that this provision of the agreement is preempted by the Federal Arbitration Act or unenforceable for various other reasons.

Because the SIA's members have a significant interest in ensuring that their arbitration contracts are enforced according to their terms, the Association tenders this amicus brief to assist the Court in its consideration of this case. The SIA has participated as amicus curiae in other cases involving issues arising in securities industry arbitrations, including *Dean Witter Reynolds Inc.* v. *Byrd*, 470 U.S. 213 (1985); *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220 (1987); and *Rodriguez de Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989).

## STATEMENT

The arbitration proceeding giving rise to this case was one of literally thousands of arbitrations that take place each year pursuant to agreements between securities firms and their customers. In 1993, for example, 6,561 cases were



received by the organizations principally involved in connection with arbitration of securities disputes. *Securities Industry Conference on Arbitration Report #8* 29 (June 1994). That represents a nearly fourfold increase over the number of cases received in 1983. *Ibid.*

A total of 5,363 cases were resolved in 1993; of those, 1,617 were decided on the merits and the remainder were settled. *Securities Industry Conference on Arbitration Report # 8*, *supra*, at 29. The increase in resolutions from 1983 to 1993 more than exceeded the increase in cases received, indicating that the arbitration fora have succeeded in keeping pace with the tremendous increase in demand for their services.

Moreover, recent analyses of the results of these arbitrations confirm the general fairness of the process: outcomes are closely divided between claimants and securities firms, with claimants winning a slightly higher percentage of the cases. Thus, the General Accounting Office found that investors prevail in 59% of the cases that they file. General Accounting Office, *Securities Arbitration — How Investors Fare* 35 (May 1992). The arbitration process also is comparatively expeditious. The GAO Study found (*id.* at 43) that securities disputes were resolved, on average, in a little over one year when arbitrated through the securities industry self-regulatory organizations (SROs) — the national exchanges and registered securities association endowed with statutory authority to regulate the securities industry (see 15 U.S.C. §§ 78f, 78*o*-3 & 78s) — whereas cases litigated in the court system took considerably longer (*id.* at 49).

Although the use of arbitration as an alternative to the judicial system dates back to practices instituted by the New York Stock Exchange in 1872, the arbitration process has evolved considerably since that time. The SROs have adopted rules governing arbitration. These rules establish procedures governing, for example, filing of a claim,

selection of arbitrators, pre-hearing discovery, the hearing, and entry of the arbitrators' decision. See generally NASD Code of Arbitration Procedure §§ 14-45. The SROs also regulate the terms of the agreement between the customer and the securities firm. See, *e.g.*, NASD Rule of Fair Practice 21(f)(1) & (2) (requiring that predispute arbitration clauses contained in post-September 1989 customer agreements "be highlighted" and disclose specified information regarding the arbitration process). Moreover, the SEC is endowed with plenary authority over SRO rules. 15 U.S.C. § 78s(b) & (c).

Some of the contracts between securities firms and their customers contain a clause similar to the one at issue here, which provides in pertinent part:

> This agreement * * * shall be governed by the laws of the State of New York. * * * [A]ny controversy arising out of or relating to [the petitioners'] accounts * * * shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as [petitioners] may elect.

Pet. App. 44.[1]

The district court concluded that this provision constituted an agreement by the parties to bar awards of punitive damages in arbitration (at least unless and until New York law changes). It found that "a customer of a brokerage firm who signs an agreement expressly governed by New York law" has agreed that punitive damages will not be available in arbitration because — under the holding of *Garrity* v. *Lyle*

[1] The selection of New York law is by no means uniform across the securities industry. Other contracts, especially those of regional securities firms, reference the law of other States.



*Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976) — New York law bars arbitrators from awarding punitive damages. Pet. App. 31, 33.

The court of appeals agreed. It stated that "the parties agreed to arbitrate all of their controversies under New York law. By choosing New York law without excluding its arbitration rules, the parties adopted *Garrity* as a binding rule." Pet. App. 12. "Given our conclusion that the parties wished to arbitrate all of their disputes subject to *Garrity*, there is no need to consider whether the *Garrity* rule is preempted by the [Federal Arbitration Act] or by the federal common law 'govern[ing] the construction of arbitration agreements.'" *Id.* at 20 (citation omitted).

## SUMMARY OF ARGUMENT

The questions before the Court in this case are in the first instance issues of state law. "The preeminent concern of Congress in passing the [Federal Arbitration] Act was to enforce private agreements into which parties had entered." *Dean Witter Reynolds, Inc.* v. *Byrd*, 470 U.S. 213, 221 (1985). The courts below concluded that the arbitration agreement's choice-of-law provision referencing New York law incorporates the *Garrity* rule barring the imposition of punishment by arbitrators. Because the parties agreed to that provision, it is binding under the Arbitration Act.

Petitioners contend that the parties' agreement should be invalidated for several reasons, all of which are meritless. They claim, for example, that availability of punitive damages provides needed deterrence of misconduct; but that contention is utterly unfounded, because existing SRO disciplinary systems ensure that any wrongdoing brought to light in arbitration will be scrutinized by expert regulators and punished when appropriate. If anything, the injection of uncontrolled punitive damages into the arbitration process will distort and undermine the comprehensive SRO disciplinary mechanisms. As for petitioners' claim that the arbitration

agreement is unconscionable, it rests on the very contentions rejected by this Court when it upheld the arbitrability of federal securities claims in *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 223-224 (1987).

Subjecting a party to liability for punitive damages in arbitration against his or her will, on the other hand, would raise concerns of fundamental fairness and constitutional due process. To the extent petitioners and their amici contend that the arbitrators are entitled to administer punishment despite the parties' contrary agreement, whether through preemption under the FAA or by operation of the SRO rules that respondent must obey under compulsion of federal law, the arbitration standards would have to satisfy due process.

This Court's decisions in *Honda Motor Co.* v. *Oberg*, 114 S. Ct. 2331, 2340 (1994), and *Pacific Mutual Life Insurance Co.* v. *Haslip*, 499 U.S. 1 (1991), establish that specific procedural protections — including, most importantly, independent review of any punitive award by a court or, perhaps, a separate appellate tribunal within the arbitration process — are essential prerequisites for a constitutional punishment regime. Because the current securities arbitration system includes no such protections, the unconsented injection of punitive damages exposure would be unconstitutional.

Finally, the government solicits an advisory opinion from the Court stating that NASD Rule 21(f)(4), which it acknowledges is inapplicable to the customer agreement here, would, where applicable, preclude enforcement of choice-of-law provisions that have the effect of barring arbitrators from imposing punitive damages. The government suggests that the meaning of the rule is so obvious that the Court should save itself the trouble of waiting to decide the question until some future case in which it actually is presented. In fact, however, it is the government's construction that is manifestly in error. The language of the rule, informed by the relevant



rulemaking history, leaves no doubt that the rule was not intended to restrict the operation of choice-of-law clauses.

## ARGUMENT

### PETITIONERS MAY NOT RECOVER PUNITIVE DAMAGES IN THE ARBITRATION PROCEEDING

#### A. The Courts Below Correctly Interpreted The Parties' Agreement As Incorporating The *Garrity* Rule.

Section 4 of the Federal Arbitration Act (FAA), 9 U.S.C. § 4, empowers the district courts to direct parties "to proceed to arbitration in accordance with the terms of the agreement." Thus, "the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." *Volt Information Sciences, Inc.* v. *Board of Trustees*, 489 U.S. 468, 476 (1989). See also *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 625 (1985) (the policy of the FAA "is at bottom a policy guaranteeing the enforcement of private contractual arrangements"); *Dean Witter Reynolds Inc.* v. *Byrd*, 470 U.S. 213, 221 (1985) ("[t]he preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered").

The critical — and dispositive — question in this case accordingly is whether the parties agreed that punitive damages would not be available if they had a dispute that went to arbitration. Both courts below concluded that by expressly choosing New York law to govern the agreement, the parties incorporated the rule of *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976), which holds that arbitrators may not award punitive damages.

This Court faced a virtually identical issue in *Volt*. The agreement there provided that "[t]he contract would be governed by the law of the place where the project is located," and the lower courts held that this choice-of-law

clause incorporated California rules of arbitration into the parties' agreement. 489 U.S. at 470, 472 (internal quotations omitted). The lower courts therefore ordered the arbitration stayed under a provision of California law authorizing a court to stay an arbitration pending the resolution of related litigation between a party to the arbitration agreement and third parties not bound by the agreement. *Id.* at 472.

Observing that "the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review," this Court declined to revisit the lower courts' determination that "by incorporating the California rules of arbitration into their agreement, the parties had agreed that arbitration would not proceed in situations which fell within the scope of" the state law stay provision. 489 U.S. at 474, 475. That same conclusion is appropriate here.

As in *Volt*, the lower courts' construction of the contract rests on their interpretation of state contract law. Accord, *Barbier* v. *Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991) (holding that the choice-of-law clause incorporates the *Garrity* rule). There simply is no reason for this Court to revisit that issue.

Moreover, again as in *Volt*, the principle that, in applying state-law rules of contract interpretation, "questions of arbitrability * * * [are to] be addressed with a healthy regard for the federal policy favoring arbitration" (489 U.S. at 475) affords no basis for setting aside the lower courts' construction of the contract. To begin with, this Court has utilized that principle only in determining whether a particular cause of action is arbitrable. See, *e.g.*, *Moses H. Cone Memorial Hospital* v. *Mercury Construction Corp.*, 460 U.S. 1 (1983). The federal policy favoring arbitration is implicated in that context because of the risk that an ambiguous contract provision could be misinterpreted and a cause of action erroneously found nonarbitrable.



When, by contrast, the question involves not the availability of arbitration but simply the standards governing the arbitration proceeding — procedures, available remedies, and the like — the Court has not invoked this federal principle of interpretation. That is because, as the Court put it in *Volt*, "[t]here is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." 489 U.S. at 476. In other words, although the FAA embodies a preference for erring on the side of overinclusiveness in determining what causes of action are subject to arbitration, the statute simply does not prefer one set of arbitration standards over another. That issue is left entirely to the parties' agreement, as construed pursuant to governing state law principles.

The government attempts (Br. 21-23) to inject the *Cone* principle into this case on two grounds, neither of which withstands scrutiny. First, it recites the truism that by agreeing to arbitrate a claim, a party does not forego the substantive rights associated with that claim. Here, of course, petitioners did more than simply agree to arbitrate; they also agreed to the application of New York law. That selection of a particular State's law may, among other things, impact upon the circumstances in which relief is available under the agreement. Surely the FAA allows parties to an arbitration agreement to make such a choice.

If the government means to assert that *Cone*'s interpretative principle extends to construing any contractual restriction on the arbitrator's authority, it is equally mistaken. *Volt* upheld a significant limitation on arbitration that, as the dissenters observed (489 U.S. at 487), effectively vitiated the right to arbitration. Even though the stay of arbitration overrode the provisions of the FAA itself, the Court held the *Cone* principle inapplicable and enforced the parties' agreement:

> [w]here, as here, the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA, even if the result is that arbitration is stayed where the Act would otherwise permit it to go forward.

489 U.S. at 479. To the extent the government's *Cone* derived "unambiguous intent" standard (see Br. 23) would override the parties' choice of state law here, it is squarely inconsistent with *Volt*. The Court there limited the arbitrator's authority based on the very same manifestation of the parties' intent relied upon by the courts below in this case — the contract's choice-of-law clause.

Second, the government asserts (Br. 22-23) that the courts below were wrong to hold that the New York choice-of-law provision incorporates *Garrity* because that decision allegedly rests on "mistrust of arbitrators." But the wisdom of and basis for the policy underlying *Garrity* is irrelevant because that rule does not apply here of its own force; it applies because the parties chose to abide by New York law. Moreover, as we discuss below (at 15-17), the government's characterization of *Garrity* is wrong.[2]

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[2] The government states (Br. 23) that "[t]he necessary consequence of the *Garrity* rule * * * is that execution of an arbitration agreement entails not simply consent to an alternative forum, but a waiver of substantive rights as well." While that observation might have some relevance in a case in which the arbitration agreement was silent or expressly provided for punitive damages awards, it is wholly inapposite here, where *Garrity* applies not because the parties executed an arbitration agreement, but rather because *the parties expressly chose to be bound by New York law*.



The *Cone* principle is inapplicable here for the additional reason that the contract is not ambiguous. The lower courts' construction of the choice-of-law clause is the same one adopted by the lower courts in *Volt*: a choice-of-law clause incorporates the state law rules governing arbitration. As the Second Circuit put it, a contract such as the one here is "clear" on that point. *Barbier*, 948 F.2d at 122.

The only possible question is whether the reference in the contract to the arbitration rules of the NASD and other SROs introduces any ambiguity into the equation. All of these rules are silent with respect to the availability of punitive damages. What they mean, we believe, is simply that the arbitrator has such powers as may be conferred by the contract. NASD Code of Arbitration Procedure § 12(a) (dispute "shall be arbitrated as provided by any duly executed and enforceable written agreement"). Accordingly, whatever the appropriate default rule might be when the contract is silent (compare *Fahnestock Co.* v. *Waltman*, 915 F.2d 512, 519 (2d Cir.) (punitive damages barred), cert. denied, 112 S. Ct. 389 (1991), with *Baravati* v. *Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 710 (7th Cir. 1994) (punitive damages allowed where there is no choice-of-law clause)), the default principle has no application to the situation in which, as here, the contract resolves the point.[3]

Petitioners argue this case (see Br. 17-58) as if the contract stated "punitive damages may be awarded in arbitra-

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[3] The court below observed (Pet. App. 15) that the NASD Arbitration Manual states that the issue of punitive damages "may" arise and arbitrators "can" consider that remedy. To begin with, the agreement refers to the NASD "rules" — the NASD Rules of Fair Practice and Code of Arbitration Procedure — not to the Manual. Moreover, the Manual does not state that punitive damages are *always* available. Rather, it recognizes that arbitrators "can" consider them — which we do not dispute, *if* the arbitration agreement allows that remedy.

tion" and the question before the Court was whether the FAA preempted the application of *Garrity* to thwart the will of the parties. But the contract said nothing of the sort; rather, it explicitly selected New York law, meaning, as discussed above, that the parties *agreed* to be bound by *Garrity*. Far from being in a position to invoke the FAA to avoid that agreement, petitioners are confounded by the FAA's policy of enforcing arbitration agreements.[4]

* * * *

In addition to addressing the questions presented in this case regarding the meaning and enforceability of the choice-of-law provision contained in the arbitration agreement, the government raises an argument not presented in the petition, contending (Br. 12-19) that the arbitrators' determination that the agreement authorized punitive damages is not subject to de novo review under Section 10 of the Federal Arbitration Act, 9 U.S.C. § 10. The SIA agrees with respondents that — for the reasons stated in their brief — the de novo review standard applies here.

### B. Relevant Policy Considerations Weigh Sharply Against Construing The Contract To Allow Awards Of Punitive Damages In Arbitration.

Petitioners and their amici advance a number of policy arguments in support of their contention that punitive damages should be available in cases such as this one. Although, as we have discussed, we believe that this case is controlled by the parties' agreement and not general policy considerations, we cannot fail to respond to these arguments.

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[4] The government's musings (Br. 26-27) about how the issue might be resolved if there were no choice-of-law provision in the contract are entirely irrelevant: the contract before the Court *does* contain such a provision, and the critical question here is the meaning of *that* contract, as the government itself recognizes (*id.* at 12, 20-25).



In fact, the relevant policy considerations fully support the court of appeals' construction of the contract.

### 1. Permitting Awards Of Punitive Damages Would Substantially Vitiate The Considerable Practical Benefits Of Securities Arbitration.

A principal attraction of the arbitration process is its speed and procedural simplicity, and therefore lower cost, in comparison to the civil litigation system. "[I]t is often a judgment that streamlined proceedings and expeditious results will best serve their needs that causes parties to agree to arbitrate their disputes; it is typically a desire to keep the effort and expense required to resolve a dispute within manageable bounds that prompts them mutually to forgo access to judicial remedies." *Mitsubishi Motors Corp.*, 473 U.S. at 633.

Securities arbitrations are far from summary proceedings, but they remain much more informal than civil litigation. Procedural and evidentiary rules are relaxed; only focused discovery is permitted; claimants are often able to present their cases without having to retain legal counsel; and arbitrators are not required to provide reasons for their decisions. NASD Code of Arbitration Procedure §§ 32, 34, 41.

Injecting punitive damages into this system would alter it in two significant respects. First, the stakes in each individual arbitration would change dramatically. Unlike the potential magnitude of compensatory damages, which usually can be estimated with some certainty, punitive damages are by their very nature uncertain. The increase in monetary stakes that would result from the addition of the "wild card" of a possible huge punitive damages award would impel defendants and claimants to devote more resources to the arbitration process. That would increase the parties' costs and prolong the process, significantly diminishing the value

of arbitration as an efficient and speedy means of settling disputes.[5]

Second, simple fairness — and likely due process requirements as well (see pages 28-31, *infra*) — would necessitate significant changes if punitive damages are broadly available in arbitration. Indeed, although petitioners and their amici attempt to paint the result in *Garrity* as resting on mistrust of arbitrators, it is in fact a decision grounded in the New York court's concern that allowing awards of punitive damages in arbitration would violate fundamental principles of fairness.

It is by now well settled that limits on the discretion of a decisionmaker awarding punitive damages are essential to prevent unfair results. "One must concede that unlimited jury discretion -- or unlimited judicial discretion for that matter — in the fixing of punitive damages may invite extreme results that jar one's constitutional sensibilities." *Pacific Mutual Life Insurance Co.* v. *Haslip*, 499 U.S. 1, 18 (1991).[6] Just last

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[5] Amicus Public Investors Arbitration Bar Association (PIABA) suggests (Br. 13) that the threat of punitive damages gives defendants an increased incentive to enter into settlements. Unfortunately, that threat operates against innocent defendants as well as guilty ones. Especially in view of the absence of procedural protections in the arbitration process, innocent parties may be forced to settle out of fear of unjustified liability. In the arbitration context, "[t]he additional incentive to settlement provided by [the threat of punitive damages] comes at too high a price in unfairness." *McDermott, Inc.* v. *AmClyde*, 114 S. Ct. 1461, 1469 (1994). Moreover, it takes two to settle, and any intimidation effect on defendants is bound to be effectively neutralized by the increase in the size of settlement demands coming from plaintiffs who see the prospect of a punitive damages bonanza.

[6] See also *id.* at 37 (Scalia, J., concurring) ("I can conceive of no test relating to 'fairness' in the abstract that would approve [the common law] procedure for awarding punitive damages"); *id.* at 42 (Kennedy, J., concurring) ("[w]ere we sitting as state-court judges,



Term, in *Honda Motor Co.* v. *Oberg*, 114 S. Ct. 2331, 2340 (1994), the Court held that due process requires judicial review of the size of punitive damages exactions, noting that they pose "an acute danger of arbitrary deprivation of property."

The *Garrity* court observed that "'[w]here punitive damages have been allowed for those torts which are still regarded somewhat as public penal wrongs as well as actionable private wrongs, they have had rather close judicial supervision.'" 353 N.E.2d at 796 (citation omitted). See also *id.* at 797 ("[u]nder common-law principles, there is eventual supervision of jury awards of punitive damages, in the singularly rare cases where it is permitted, by the trial court's power to change awards and by the Appellate Division's power to modify such awards").

The court's objection to the imposition of punitive damages by arbitrators was that "'[i]f the usual rules were followed there would be no effective judicial supervision over punitive awards in arbitration,'" because of the very deferential judicial review of arbitrator's awards. *Garrity*, 353 N.E.2d at 796 (citation omitted). "It would mean that the scope of determination by arbitrators, by the license to award punitive damages, would be both unpredictable and uncon-

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the size and recurring unpredictability of punitive damages awards might be a convincing argument to reconsider those rules or to urge a reexamination by the legislative authority"); *ibid.* (O'Connor, J., concurring) ("[i]mposed indiscriminately, * * * [punitive damages] have a devastating potential for harm. Regrettably, common law procedures for awarding punitive damages fall into [that] category"); *Gertz* v. *Robert Welch, Inc.*, 418 U.S. 323, 350 (1974) ("In most jurisdictions jury discretion over the amounts [of punitive damages] awarded is limited only by the gentle rule that they not be excessive. Consequently, juries assess punitive damages in wholly unpredictable amounts bearing no necessary relation to the actual harm caused").

trollable." *Ibid.* That would amount to "'an unlimited draft upon judicial power'" because the courts would be obliged to enforce these "penal sanctions." *Ibid.* (citation omitted).

Indeed, arbitration closely resembles the jury system in significant respects. Securities arbitrators are not required to have a legal background and, in all cases involving disputes with customers, the majority of an arbitration panel must be composed of members of the general public. NASD Code of Arbitration Procedure § 19. Like juries, moreover, arbitration panels need not explain their determinations.

And the threat of unpredictable arbitral awards of punitive damages is not an empty one. One study found that the average arbitral punitive award in the first six months of 1992 was more than double the average for the prior six months. 5 *Securities Arbitration Commentator*, Chart D (May 1993). Indeed, despite the ongoing dispute about the availability of punitive damages, arbitrators are imposing substantial penalties in a number of cases.[7]

A decision broadly empowering arbitrators to impose punitive damages would therefore require, at a minimum, creation of a separate appellate tribunal to review punitive awards imposed by arbitration panels or, alternatively, provision for substantive judicial review of arbitral punishments. And, in order that review could be meaningful, arbitrators would have to memorialize in writing the grounds for their punitive damages decision. These changes by themselves would obviously have a dramatic impact on the efficiency — and the cost — of the arbitration process.

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[7] See, *e.g.*, *Gage* v. *CIGNA Sec., Inc.*, No. 90-01371 (NASD Mar. 10, 1992) ($3.5 million); *Hickman* v. *PaineWebber, Inc.*, No. 90-03354 (NASD Sept. 9, 1992) ($1.7 million); *Harper* v. *Shearson Lehman Bros., Inc.*, No. 91-00508 (NASD Mar. 26, 1992) ($1 million); *Robertson* v. *Prudential Bache*, No. 33 136 00114 92 00 (AAA July 26, 1993) ($700,000).



Moreover, the SROs would have to give careful consideration to incorporating other procedural protections that courts and legislatures have found appropriate to ensure fairness in the punishment decision. Indeed, given the purposes of punitive damages, the stigma that may be suffered by a defendant found to have committed the kind of outrageous acts that warrant punitive damages, and the importance to the industry as a whole that punishments be rational in amount and generally consistent from one case to another, procedural protections equivalent to those available in the disciplinary process would be appropriate. These additional protections — clear, detailed standards to guide arbitration panels in the initial decision whether to award punitive damages, a heightened burden of proof, and some form of guidelines to be employed in setting the amount of punishment that is appropriate in various circumstances — would also increase the complexity and cost of the arbitration proceeding.

Changes of this nature, however essential to a fair punishment regime, would to a large extent vitiate the benefits of simplicity and speed that prompted creation of the arbitration process in the first place. Moreover, as we next discuss, these very substantial impairments of the arbitration process would yield no countervailing benefits, because the purposes of punishment and deterrence are already served by the existing disciplinary process.

### 2. In View Of The Pervasive Regulatory Oversight Of The Securities Industry, Arbitral Punishment Is Not Necessary To Deter Securities Violations.

Amicus PIABA contends (Br. 13-22) that availability of punitive damages is necessary to deter misconduct by securities firms. That is entirely wrong. The existing SRO disciplinary systems, supplemented by federal and state governmental oversight of the securities industry, already

ensure that any wrongdoing brought to light in arbitration will be scrutinized by expert regulators and that penalties sufficient to punish and deter misconduct will be imposed when appropriate. The injection of punitive damages into securities arbitrations will, if anything, jeopardize the effectiveness of these thorough and carefully calibrated disciplinary mechanisms.

All securities firms and their employees are subject to comprehensive regulation by a statutory self-regulatory organization — the National Association of Securities Dealers ("NASD"). See 15 U.S.C. § 78*o*(b)(8) (requiring all broker-dealers with retail customers to belong to a national securities association registered with the SEC; the NASD is the only such association). The federal securities laws and regulations, the NASD By-Laws, and the NASD Rules of Fair Practice establish a comprehensive code of conduct governing every aspect of the business of member firms.[8] The task of ensuring compliance with these standards — and imposing appropriate disciplinary sanctions for violations — is entrusted in the first instance to the District Business Conduct Committees (DBCCs), which are located in each of the NASD's 11 districts, and the Market Surveillance Committee (MSC), a central committee responsible for reviewing alleged violations of market-related rules.

There simply is no realistic danger that a claim of wrongdoing lodged against an NASD member would escape the attention of these disciplinary committees. There are a variety of means by which the disciplinary process could be triggered:

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[8] See, *e.g.*, 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; NASD Rules of Fair Practice Art. III, § 1 ("[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade"); see generally *id.* Art. III.



- "[a]ny person" who feels aggrieved by an act of a member or person associated with a member may file a complaint with a DBCC;[9]
- arbitrators may refer a matter for disciplinary investigation if they have "reason to believe [there has been conduct that] may constitute a violation of the [NASD] rules or the federal securities laws";[10]
- NASD members and associated persons must report most allegations of misconduct to the Central Registration Depository, and the NASD regularly monitors these reports;[11]
- evidence of misconduct may be detected in the course of the regular examination of an NASD member or the NASD's ongoing market surveillance program.[12]

Sanctions for violations include fines, suspension, expulsion from the securities industry, restitution, or any other appropriate measure. NASD Notice to Members 93-32 (May 1993). And the NASD's decisions are reviewed by the SEC. 15 U.S.C. § 78s. The Securities and Exchange Commission has recognized the effectiveness of the program. See, *e.g.*, SEC, *Annual Report - 1990* 42 (the NASD "operates an effective and thorough [disciplinary] program").

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[9] NASD Rules of Fair Practice Art. IV, § 2.

[10] NASD Code of Arbitration Procedure, § 5.

[11] NASD By-Laws Art. IV & Schedule C.

[12] NASD Rules of Fair Practice Art. IV, § 3; see also NASD, Disciplinary Procedures 6, 12-13 (1990).

Moreover, the conduct of member firms and associated persons is also regulated by the relevant government agencies. The SEC has its own authority to discipline broker-dealers for violations of federal law and regulations (15 U.S.C. § 78*o*); it may institute enforcement proceedings seeking civil monetary penalties (15 U.S.C. § 78u-2); and it may refer matters to the Department of Justice for criminal prosecution (15 U.S.C. §§ 78u, 78u-1, 78ff). State regulators have similar oversight authority.[13]

The private disputes adjudicated in the SRO arbitration system are thus fundamentally different from those in the civil litigation system: the securities industry already has in place mechanisms fully capable of effectuating society's interest in punishing and deterring wrongdoing that might be the subject of punitive damages claims in arbitrations. And federal and state agencies are specifically charged with ensuring that securities firms and their employees do not violate applicable standards of conduct. Accordingly, the purpose underlying punitive damages does not apply here: there simply is no need to invest individual litigants with power to act as unsupervised "private attorneys general" when the SRO disciplinary and enforcement process, supplemented by government regulators, already is performing that function in a fully satisfactory manner. The case is in this respect just like *INS* v. *Lopez-Mendoza*, 468 U.S. 1032 (1984), which held that application of the exclusionary rule in deportation proceedings was not justified because of existence of a meaningful administrative disciplinary regime.

Indeed, because the SRO disciplinary process is funded in significant part by the fines collected in disciplinary

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[13] See, *e.g.*, Ariz. Rev. Stat. Ann. §§ 44-1961 to 44-1962, 44-1991, 44-1995, 44-2036 to 44-2037 (1994); Colo. Rev. Stat. §§ 11-51-410 to 11-51-501, 11-51-601 to 11-51-603 (1994); Vt. Stat. Ann. tit. 9, §§ 4221a, 4224a-4225a (1994).



proceedings, and fairness would require those fines to be diminished or abated to reflect penalties already imposed on defendants by arbitrators, the injection of punitive damages into securities arbitration would actually *undermine* the goal of rational, fair, and effective deterrence of wrongdoing.

### 3. The Contract Provision Is Not Unconscionable.

Petitioners (Br. 58-69) and their private amici (PIABA Br. 23-32; American Ass'n of Limited Partners (AALP) Br. 21-28) contend that if the contract bars the award of punitive damages in arbitration, it is unconscionable. They advance a bewildering array of charges in support of that proposition. All of them are meritless.

To begin with, petitioners' unconscionability argument necessarily rests on state law. Their claim for punitive damages arises solely under state law; the federal securities laws do not provide for awards of punitive damages (see 15 U.S.C. § 78bb(a)).[14] The question whether public policy invalidates an agreement barring punitive damages awards accordingly must be answered by reference to state law.[15] Insofar as petitioners' claim is that the entire contract is unconscionable, that issue too is one of state law. Neither petitioners nor their amici discuss state-law unconscionability standards or explain why this Court should address these state-law issues. Moreover, the factors that petitioners and the amici cite to justify their conclusion are utterly unconvincing.

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[14] Thus, petitioners' reliance (Br. 59) on the "federal goal of investor protection" is entirely misplaced.

[15] For that reason, petitioners' citation (Br. 67-68) of this Court's statement in *Mitsubishi Motors* regarding federal statutory claims is inapposite.

First, petitioners argue (Br. 60) that the effectiveness of their "waiver" of punitive damages must be evaluated under the "intentional relinquishment or abandonment of a known right or privilege" standard established in *Johnson* v. *Zerbst*, 304 U.S. 458, 464 (1938). See also PIABA Br. 30-31; AALP Br. 21. While that standard may govern some waivers of constitutional rights, we know of no case invoking it to measure the validity of a commercial contract between private parties, and petitioners have cited none. Given the many circumstances in which contract provisions are interpreted to apply to unforeseen circumstances, petitioners' approach would effect a substantial reordering of basic principles of contract law.[16]

Petitioners' argument also depends on the existence of a "right" to punitive damages. But petitioners have no such right. Punitive damages "'are not compensation for injury. Instead, they are private fines levied * * * to punish reprehensible conduct and to deter its future occurrence.'" *Electrical Workers* v. *Foust*, 442 U.S. 42, 48 (1979) (citation omitted). They are thus "a windfall to a fully compensated plaintiff," not a sum to which he or she has an entitlement by virtue of a status as an injured party. *City of Newport* v. *Fact Concerts, Inc.*, 453 U.S. 247, 267 (1981). "So far is this opportunity [to recover punitive damages] from being a fundamental personal right that it is an interest not truly personal in nature at all. It is rather a public interest * * *." *In re Paris Air Crash*, 622 F.2d 1315, 1319-1320 (9th Cir.) (Kennedy, J.), cert. denied, 449 U.S. 976.

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[16] Petitioners' argument rings hollow in view of the fact that at the time they entered into the agreement, industry members had clearly staked out the position that the choice-of-New-York-law clause barred imposition of punitive damages. See, *e.g.*, *Pierson* v. *Dean Witter Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984) (holding punitive damages barred by choice-of-law clause).



Third, PIABA suggests (Br. 25-26) that the securities arbitration system is tilted in favor of the securities industry. This is a wholly unfounded assertion. In reality, impartial studies show that claimants prevail *more often* than defendants (see page 3, *supra*). Thus, the General Accounting Office's "analysis of statistical results of decisions in arbitration cases at both industry-sponsored and independent forums showed no indication of a pro-industry bias in decisions at industry-sponsored forums." GAO, *supra*, at 6.

Finally, petitioners' entire argument ignores the fact that the arbitration process — and the customer contracts incorporating agreements to arbitrate — are closely supervised by the statutory self-regulatory organizations and the SEC. As this Court has observed, the Securities and Exchange Commission "has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes." *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 233-234 (1987). See also SEC Am. Br. at 13, *Shearson/American Express Inc.* v. *McMahon*, *supra* ("the Commission has had the power to ensure that the arbitration procedures prescribed by the SROs are adequate to enforce the rights of customers against brokerage firms that are members of the SROs"). Those expert bodies have approved the arbitration process now in place. That imprimatur is dispositive of petitioners' public policy arguments. Cf. *McMahon*, 482 U.S. at 234 ("[w]e conclude that where, as in this case, the prescribed procedures are subject to the Commission's * * * authority, an arbitration agreement does not effect a waiver of the protections of the Act").[17]

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[17] Since this Court's decision in *McMahon*, moreover, the arbitration process has been revised to incorporate still more procedural protections for claimants. See, *e.g.*, NASD Code of Arbitration Procedure §§ 19(c) (definition of "industry" arbitrator amended to ensure that even individuals with a remote connection to the securities industry are not named as "public" representatives

### C. NASD Rule 21(f)(4) Does Not Override Contractual Choice-of-Law Provisions.

Petitioners (Br. 56-57) and their amici (U.S. Br. 10; AALP Br. 4; PIABA Br. 28) cite NASD Rule of Fair Practice 21(f)(4), arguing that it is somehow relevant to the dispute in this case (or, in the case of the United States and the SEC (Br. 7, 12) that its meaning should be ruled upon even if it is not applicable to the current dispute). As the government acknowledges (Br. 12), however, that rule by its terms applies only to contracts entered into after September 7, 1989 (see NASD Rule of Fair Practice 21(f)(5)) and therefore has no relevance to this case because petitioners' contract was signed in 1985. Pet. App. 2-3. Moreover, petitioners and the amici are wrong in their view that, if applicable, the rule would override the effect of the parties' choice of New York law on the availability of punitive damages.

#### 1. Petitioners' Construction Makes No Sense And Is Inconsistent With The Rule's History.

The relevant portion of Rule 21(f)(4) states that an arbitration agreement may not include "any condition which * * * limits the ability of the arbitrators to make any award." Read literally, as petitioners do, the rule would prohibit all choice-of-law clauses, because such clauses necessarily limit the arbitrator's authority by mandating the application of one State's law. If an arbitration agreement references New York law, that law must apply, even if the claimant otherwise could have argued for the application of, for example, more favorable Texas law. Petitioners' reading of the rule, however, would require arbitrators to apply the law most favorable to the claimant on every issue.

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on arbitration panels); 23(a) (arbitrators must disclose past or current relationships with parties); 32-33 (pre-hearing discovery expanded); 41 (enhanced availability of arbitration results).



NASD did not intend to forbid the use of a clause that appears in almost every arbitration agreement. Indeed, securities firms continue to include choice-of-law clauses in their customer agreements and the NASD has never taken any action to bar that well-settled practice. The rule permits choice-of-law clauses and bars only contract provisions that expressly limit an arbitrator's authority — for example, by imposing time limits for filing claims or fixing an upper limit on potential damages awards, even though applicable state law would not do so.

Indeed, the SEC Release approving adoption of the rule is consistent with this view; it states only that "[i]f punitive damages * * * would be available under *applicable law*, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them." 54 Fed. Reg. 21144, 21154 (1989) (emphasis added). See also NASD Notice to Members 88-87 at 2 (Nov. 1988) (describing Rule 21(f)(4) as barring contract conditions that would "limit[] the ability of an arbitrator * * * to make [a punitive] award under [SRO] rules *and applicable law*") (emphasis added). Where there is a choice-of-law clause, that provision supplies the "applicable law." Thus, the rule does not bar the operation of clauses such as the one present in the agreement in this case.[18]

Moreover, this rule was adopted at a time when a number of NASD members were engaged in litigation

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[18] The SEC relies (Br. 10) on language in its release stating that "[a]greements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum." But the agency's construction of that sentence suffers from the same problem as petitioners' interpretation of the plain language of the rule: it would bar choice-of-law clauses altogether, because such clauses eliminate a party's right to invoke the law of various jurisdictions. That sentence is most logically interpreted by reference to the next one, which — as noted in the text above — expressly preserves choice-of-law clauses.

concerning availability of punitive damages in arbitration. It is inconceivable that this contentious issue — which produced numerous published decisions and law review articles during the very period the rule was under consideration — was resolved *sub silentio* by the NASD's adoption of this rule.

The history of rulemaking in this area confirms this conclusion. Shortly after the Second Circuit's 1991 decision in *Barbier* holding that the New York choice-of-law provision bars awards of punitive damages, the Securities Industry Conference on Arbitration (SICA) amended its uniform rules to add the following provision:

> The arbitrator(s) may grant any remedy or relief that the arbitrator(s) deem just and equitable and that would have been available in a court with jurisdiction over the matter.

Uniform Code of Arbitration § 28(h). This new provision obviously would not have been necessary if Rule 21(f)(4) — adopted by SICA several years earlier — had the meaning ascribed to it by petitioners. On that view, Section 28(h) would be entirely superfluous because Rule 21(f)(4) already fulfilled that purpose. SICA's decision to adopt Section 28(h), together with the fact that Section 28(h) is one of the few provisions of the Uniform Code of Arbitration that has *not* been adopted by the NASD and other SROs, provides conclusive evidence that Rule 21(f)(4) does not override choice-of-law clauses.

Indeed, in connection with a change in NASD rules making it clearer that arbitrators may, in conjunction with or in lieu of an award of punitive damages, refer matters for a disciplinary investigation, the SEC noted that the NASD was "not expressing any official position with respect to the ability of arbitrators to award punitive damages." 59 Fed. Reg. 36242, 36243 n.7 (1994). The NASD — which, after all, is the best source regarding the meaning of its own rules — obviously would not have included that caveat if it had



definitively resolved the issue when it promulgated Rule 21(f)(4). The rule simply does not have the broad meaning attributed to it by petitioners.

### 2. Petitioners' Interpretation Of The Rule, If Adopted, Would Raise Serious Questions About The Constitutionality Of The Current Arbitration System.

If petitioners were correct about the meaning of Rule 21(f)(4), the forced subjection of defendants to punitive damages exposure in securities arbitration would raise the fairness concerns discussed above (see pages 13-18, *supra*) to the level of a due process violation. That fact weighs strongly against petitioners' interpretation of the rule.

Although the rule was adopted by the NASD rather than the SEC, there is governmental involvement sufficient to trigger application of the due process requirement. First, federal law requires that broker-dealers be members of the NASD, and thus subject to NASD arbitration provisions. See page 19, *supra*. The government may not compel membership in an organization whose rules would violate the Constitution if imposed directly by the government. In *Keller* v. *State Bar of California*, 496 U.S. 1, 11 (1990), for example, the Court stated that even though the state bar association was "a good deal different from most other entities that would be regarded in common parlance as 'governmental agencies,'" its rules were subject to First Amendment constraints because "all * * * lawyers admitted to practice in the State must be members."

Similarly, in the labor area, the Court has found constitutional limitations applicable to union activity where a statute either requires employees to be members of a union or authorizes unions and employers to agree that non-union employees would make payments to a union in lieu of dues. See, *e.g.*, *Abood* v. *Detroit Board of Education*, 431 U.S. 209 (1977); *Railway Employees' Dept.* v. *Hanson*, 351 U.S.

225 (1956). In *Moose Lodge No. 107* v. *Irvis*, 407 U.S. 163 (1972), the Court found that racially discriminatory by-laws of a private organization became imbued with governmental action by virtue of a requirement of state law that the organization adhere to its own by-laws. As the Court explained (*id.* at 178-179):

> Even though the Liquor Control Board regulation in question is neutral in its terms, the result of its application in a case where the constitution and by-laws of a club required racial discrimination would be to invoke the sanctions of the State to enforce a concededly discriminatory private rule. * * * [T]he application of state sanctions to enforce such a rule would violate the Fourteenth Amendment.

The compulsory membership provision in the federal securities laws binds NASD members to the arbitration procedures adopted by the NASD in the same way the lawyers and union members were obligated to comply with the rules of their state bar association and their unions. These decisions therefore provide especially strong support for the application of due process standards to the NASD arbitration system.[19]

That conclusion is bolstered by special considerations relating to punitive damages. The imposition of sanctions to punish and deter misconduct — which are the purposes of

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[19] This argument is substantially reinforced by the nature of the government's involvement here. In addition to the statutory requirement that broker-dealers be members of the NASD, the SEC is given sweeping authority over the NASD, including the power to amend NASD rules to ensure the fair administration of the Association or further the purposes of the securities laws. See 15 U.S.C. § 78s(b) & (c). This highly unusual grant of plenary authority to the Commission enhances the government's involvement in and responsibility for the NASD's rules.



punitive damages — is, like criminal law, within the traditional and exclusive province of the state.[20] That the function at issue has been "'traditionally the exclusive prerogative'" of the government[21] is an additional important consideration supporting the application of due process standards to the procedure for awarding punitive damages in arbitration.

For the foregoing reasons, the due process requirements set forth in Court's decisions in *Honda Motor Co.* and *Haslip* apply with full force to NASD arbitration proceedings in which punitive damages are sought. As in the judicial system, imposition of punishment in an arbitration process in which NASD members are forced to participate poses "an acute danger of arbitrary deprivation of property." *Honda*, 114 S. Ct. at 2340.

Any punitive award accordingly would have to be subject to independent review by a court, pursuant to the decision in *Honda*, together with the other procedural protections outlined above. See pages 16-18, *supra*. Because those protections are not present in the current system, an award of punitive damages would violate the Constitution. Rather than construing the rule in a manner that renders it unconstitution-

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[20] *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793, 796 (N.Y. 1976) ("[p]unitive damages is a sanction reserved to the State"). See also *Edmonson* v. *Leesville Concrete Co.*, 500 U.S. 614, 625 (1991) (in civil punitive-damages cases, "the jury can weigh the gravity of a wrong and determine the degree of the government's interest in punishing and deterring willful misconduct. * * * [This is a] traditional function[] of government"); *Georgia* v. *McCollum*, 112 S. Ct. 2348, 2355 (1992) ("the selection of a jury in a criminal case fulfills a unique and constitutionally compelled governmental function").

[21] *San Francisco Arts & Athletics* v. *United States Olympic Comm.*, 483 U.S. 522, 544 (1987) (emphasis omitted).

al, it is appropriate to interpret it to avoid casting a doubt on the arbitration process.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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